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Municipal Bond Offerings: MSRB Propose Rules of Conduct for Municipal Advisors

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In two recent filings with the Securities and Exchange Commission ("SEC"), the Municipal Securities Rulemaking Board ("MSRB") proposed important new standards of conduct for municipal advisors under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act amended Section 15B of the Securities Exchange Act of 1934 (the "Exchange Act") to provide for the regulation of municipal advisors, with registration, examination, enforcement and related responsibilities vested in the SEC and general rulemaking responsibilities vested in the MSRB.

In its filing on **August 23, 2011**, the MSRB proposed **Rule G-36** (on fiduciary duties) and a proposed interpretive notice concerning the application of **Rule G-36** to municipal advisors. In its filing on **August 24, 2011**, the MSRB proposed an interpretive notice concerning the application of existing **Rule G-17** (on fair dealing) to municipal advisors. As discussed below, the proposed changes set forth in the two filings do not go into effect prior to the effective date of new SEC rules defining the term "municipal advisor."

Click here to view the August 23, 2011 filing (176 pages).

Click here to view the August 24, 2011 filing (142 pages).

August 23, 2011 Filing: Section 15B(c)(1) of the Exchange Act provides that a municipal advisor shall be "deemed to have a **fiduciary duty**" to its municipal entity clients. Further, Section 15B(b)(2)(L)(i) of the Exchange Act requires the MSRB to establish rules that "prescribe means reasonably designed to prevent acts, practices, and courses of business as are not consistent with a municipal advisor's **fiduciary duty** to its clients." On February 14, 2011, the MSRB released a draft of **Rule G-36** and a draft interpretive notice concerning the application of **Rule G-36** to municipal advisors and requested public comment. In response to numerous comments, the MSRB issued the August 23rd filing modifying the draft interpretive notice. For a listing of various comments on the draft notice and the MSRB's responses, please see pages 18-34 of the August 23rd filing.

As set forth in the August 23rd filing, **Rule G-36** briefly states: "In the conduct of its municipal advisory activities on behalf of municipal entity clients, a municipal advisor shall be subject to a fiduciary duty, which shall include a **duty of loyalty** and **a duty of care**."

The interpretive notice included with the August 23rd filing provides that a municipal advisor's **duty of loyalty** requires it to deal honestly and in good faith with its municipal entity clients and to act in the client's best interest without regard to the interests of the municipal advisor. Specifically, under its **duty of loyalty**:

- A municipal advisor must clearly disclose in writing all material conflicts of interest of which it is aware after reasonable inquiry, including those existing at the time the engagement is entered into and those discovered or arising during the course of the engagement;

- A municipal advisor must receive written, informed consents to its conflicts by an official to the municipal entity client that the municipal advisor reasonably believes can bind the municipal entity;

- A municipal advisor must not undertake an engagement if certain "unmanageable conflicts" exist, such as kickbacks or fee-splitting arrangements with the providers of investments or services to the municipal entity client; and

- A municipal advisor must not receive excessive compensation for its service, even if such compensation has been disclosed; provided that the reasonableness of compensation will vary depending upon various factors, including, expertise of the municipal advisor, complexity of the financing, whether the fee is contingent, and length of time of the transaction.

The interpretive notice also provides that a municipal advisor has a **duty of care** requiring it to exercise due care in performing its responsibility; however, a municipal advisor's duty of care does not make it a guarantor of a successful transaction or a guarantor that there are no facts material to a municipal entity's decision-making other than the ones known by the municipal advisor and disclosed to the municipal entity. Specifically, under its **duty of care**:

- A municipal advisor must not accept an engagement for which the municipal advisor "does not possess the degree of knowledge and expertise needed to provide the municipal entity with informed advice";

- Unless expressly disclaimed, a municipal advisor must investigate and advise the municipal entity client of alternative financing structures or products it reasonably deems would better serve the municipal entity's interests;

- A municipal advisor must make a reasonable inquiry as to the facts that are relevant to a municipal entity client's determination of whether to proceed with a course of action (*e.g.*, issuance of securities, entering into a derivative transaction, making an investment); and

- When a municipal advisor participates in the preparation of an offering document for a security issue, the municipal advisor must make reasonable inquiries to help ensure that appropriate disclosures are made.

August 24, 2011 Filing: Section 15B(b)(2)(c) of the Exchange Act directs the MSRB to adopt rules that are "designed to prevent fraudulent and manipulative acts and practices . . . and, in general, to protect investors, municipal entities, obligated persons, and the public interest . . .." Accordingly, in December 2010, the MSRB amended **Rule G-17** to provide as follows:

In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall **deal fairly** with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

On February 14, 2011, the MSRB released a draft interpretive notice providing guidance on how **Rule G-17** applies to municipal advisors and requesting public comments on the draft notice. In response to numerous comments, the MSRB issued the August 24th filing modifying the draft notice. Notably, in response to a comment from the Securities Industry and Financial Markets Association, the MSRB modified the draft notice to substitute the term "**suitability**" for "**appropriateness**" throughout the interpretive notice and to provide that a municipal advisor must have reasonable grounds for believing that a recommended municipal securities transaction or municipal financial product is **suitable** for the client, based on certain information about the client and the product or transaction known by the municipal advisor. For a listing of various comments on the draft notice and the MSRB's responses, please see pages 19-27 of the August 24th filing.

Many of the "fair dealing" standards set forth in the August 24th filing closely parallel the "fiduciary duty" standards set forth in the August 23rd filing. Among the unique "fair dealing" standards are the following:

- All representations made by municipal advisors to their issuer clients, whether written or oral, must be truthful and accurate and must not omit material facts; and matters not within the personal knowledge of those preparing a response (*e.g.*, pending litigation) must be confirmed by those with knowledge of the subject matter; and

- While municipal advisors are not required to exercise a fiduciary duty when soliciting municipal entities on behalf of third parties, they must deal fairly and not engage in conduct that is deceptive, dishonest, or unfair.

The proposed interpretive notice included in the August 23rd filing makes it clear, however, that "[t]he **Rule G-36** fiduciary duty to municipal entity clients . . . encompasses the obligation under MSRB **Rule G-17** for municipal advisors, in the conduct of their municipal advisory services . . . ." Accordingly, a municipal advisor's violation of **Rule G-17** with respect to a municipal entity client "would necessarily be a violation of **Rule G-36**."

Effective Date: Each of the August 23rd and August 24th filings states that it will be effective on the date that rules defining the term "municipal advisor" under the Exchange Act are first made effective by the SEC or such later date as determined by the SEC. On December 20, 2010, the SEC issued SEC Release No. 34-63576 proposing new SEC Rules 15Ba1-1 through 15Ba1-7 that, among other things, would define the term "municipal advisor." As of this date, the SEC has not made any rule effective defining the term "municipal advisor."

Comments: As stated in each filing, interested persons are invited to submit comments on the proposed rule changes included in the filing. Comments should be submitted on or before the 21st day from publication of the proposed rule change in the Federal Register (which is expected shortly).

UPDATE: MSRB Withdraws Pending Municipal Advisor Rule Proposals

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