The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 27825

January 9, 2014

MSRB Publishes Proposed Conduct Rule for Municipal Advisors; Call to Discuss Scheduled for Thursday, Jan. 16th at 2pm Eastern

[27825]

January 9, 2014

TO: MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 1-14
INVESTMENT ADVISERS COMMITTEE No. 1-14
529 PLAN ADVISORY COMMITTEE No. 2-14 RE: MSRB PUBLISHES PROPOSED CONDUCT RULE FOR MUNICIPAL ADVISORS; CALL TO DISCUSS SCHEDULED FOR THURSDAY, JAN. 16th AT 2PM EASTERN

As you know, the Municipal Securities Rulemaking Board ("MSRB") has been charged with writing rules to implement the provisions of the Dodd-Frank Act that require the registration and regulation of municipal advisors. Pursuant to this authority, and consistent with the recent rulemaking by the Securities Exchange Commission that defines the term "municipal advisor" and imposes registration and recordkeeping requirements on such persons, the MSRB has proposed for comment a new MSRB Rule G-42, which would establish core standards of conduct and duties of municipal advisors. [1] The proposal is briefly summarized below.

Comments on the proposal must be filed with the MSRB by March 10, 2014. To assist the Institute in preparing a comment letter, we are planning to hold a member call on Thursday, January 16th from 2-3:15 p.m. [Eastern]. If you are interested in participating in the call, you must contact Jennifer Odom by phone (202-326-5833) or email (jodom@ici.org) to obtain the call-in information. If you are unable to participate in the call but have issues you would like the Institute to consider including in its letter, please provide them to either Jane Heinrichs (jheinrichs@ici.org; 202-371-5410) or Tami Salmon (tamara@ici.org; 202-326-5825) prior to the call.

Summary of Proposed Rule G-42, Duties of Non-

Solicitor Municipal Advisors [2]

As proposed, Rule G-42 would consist of seven substantive sections, one definitional section, and ten items of supplementary material. The components of the proposed rule and their contents are as follows:

Subsection (a), Standards of Conduct

Subsection (a) of the rule would subject all municipal advisors to both a "duty of care" and a "fiduciary duty that includes a duty of loyalty and a duty of care." Supplementary Material .01 and .02 provide more detail regarding what these duties consist of.

Related Supplementary Material .01 – Duty of Care

According to Supplementary Material .01, a municipal advisor's duty of care means, without limitation, that the advisor must:

- Exercise due care in performing its municipal advisory activities;
- Possess the degree of knowledge and expertise needed to provide the client (e.g., the municipal entity) with informed advice;
- Make a reasonable inquiry as to the facts that are relevant to a client's determination as to whether to proceed with a course of action or that form the basis for any advice provided to the client; and
- Undertake a reasonable investigation to determine that the municipal advisor is not basing any recommendation on materially inaccurate or incomplete information.

Supplementary Material .01 also requires, "among other matters," that a municipal advisor have a reasonable basis for: (1) any advice provided to or on behalf of a client; (2) any representations made in a certificate that it signs that foreseeably will be relied upon by the client, other parties to the transaction, or investors; and (3) any information provided to the client or other parties involved in the transaction when participating in the preparation of an official statement. According to the Notice, this Supplementary Material also requires a municipal advisor engaged in an issuance of municipal securities to "undertake a thorough review of the official statement for that issue unless otherwise directed by the client and so documented in writing." [3]

Related Supplementary Material .02 – Duty of Loyalty

As defined in Supplementary Material .02, a municipal advisor's duty of loyalty requires it to deal honestly, with the utmost good faith, and in the client's best interest without regard to the financial or other interests of the advisor. This duty also requires the municipal advisor to "either eliminate or provide full and fair disclosure to the client about each of its material conflicts of interest" and to "investigate or consider other reasonably feasible alternatives to any recommended municipal securities transaction or municipal financial product that might also or alternatively serve the municipal entity client's objectives." [4]

Subsection (b), Disclosure of Conflicts of Interest and Other Information

Subsection (b) of the rule would require a municipal advisor "at or prior to the inception" of the advisory relationship to provide the client "with a document making full and fair disclosure of all material conflicts of interest." The rule expressly requires disclosure of nine different potential conflicts, including among others those relating to affiliates of the advisor, fee arrangements, compensation, other engagements, and disciplinary events. [5]

It also provides that, if the advisor concludes it has no material conflicts of interest, it must provide “written documentation to the client to that effect.”

Related Supplementary Material .05 – Conflicts of Interest

Supplementary Material .05 specifies that the required disclosure of conflicts of interest “must be sufficiently detailed to inform the client of the nature, implications and potential consequences of each conflict.” The disclosure must also “include an explanation of how the advisor addresses or intends to manage or mitigate each conflict.”

Related Supplementary Material .07 – to Disclosure to Investors

A provision in the Supplementary Material that references subsection (b) is Supplementary Material .07. It provides that, if any document provided by the advisor or its affiliates is included in an official statement relating to an issuance of municipal securities by the client, “the municipal advisor must provide written disclosure to investors, which disclosure may be provided in the official statement, of any affiliation that meets the criteria of subsection (b)(ii) of the rule.” [Emphasis added.]

Subsection (c), Documentation of Municipal Advisory Relationship

Subsection (c) of the proposed rule would require every municipal advisor to “evidence each of its municipal advisory relationships by a writing entered into prior to, upon or promptly after the inception of the municipal advisory relationship.” This writing, which is not required to be a two-party agreement, [6] must be dated and include, at a minimum, the following six items of information:

1. The form and basis for the advisor’s direct or indirect compensation, if any;
2. The reasonably expected amount of any such compensation (in dollars if it can be quantified);
3. The conflict of interest information required by subsection (b) of the rule;
4. The scope of the advisor’s advisory activities and any limitations on the scope of its engagement;
5. With respect to new issue offerings or reofferings, the specific undertakings, if any, that the advisor will perform in connection with the preparation and finalization of an official statement or similar disclosure document; and
6. The date, triggering event, or means for terminating the advisory relationship or, if none exists, a statement to that effect.

Subsection (c) also requires that, during the term of the advisory relationship, the required writing must be promptly revised or supplemented “to reflect any changes in or addition to” its terms. However, information regarding the amount of the reasonably expected compensation is only required to be revised if the changes to its terms are “material.”

Subsection (d), Recommendations

Subsection (d) would prohibit a municipal advisor from recommending that a municipal entity or “obligated person” client enter into any municipal transaction or product unless the advisor reasonably believes that the transaction or product is suitable for the client “based on the information obtained through the reasonable diligence of the advisor.” [7] It additionally requires that the advisor discuss with the client the following:

1. The advisor’s evaluation of the material risks, potential benefits, structure, and other characteristics of the recommended transaction/product;

2. The basis upon which the adviser believes the transaction/product is suitable for the client; and
3. Whether the adviser has investigated or considered alternatives to the transaction/product that might serve the client's objectives.

Related Supplementary Material .08 – Suitability

According to Supplementary Material .08, the advisor's suitability determination "must be based on the client's financial situation and needs, objectives, tax status, risk tolerance, liquidity needs, experience with municipal securities transactions or . . . products . . ., financial capacity to withstand changes in market conditions . . ., and any other material information known" by the advisor about the municipal entity "after reasonable inquiry." [8]

Related Supplementary Material .09 – Know Your Client

According to the Notice, Supplementary Material .09, which requires an advisor to know their client, is patterned after similar rules of FINRA and the Commodity Futures Trading Commission. This Supplementary Material requires an advisor to use reasonable diligence "to know and retain the essential facts concerning the client and concerning the authority of each person acting on behalf of such client." These "essential facts" include those necessary to: effectively service the relationship with the client; act in accordance with the client's special directions; understand the authority of persons acting on behalf of the client; and comply with applicable laws, regulations, and rules.

Subsection (e), Review of Recommendations of Other Parties

Subsection (e) of the rule requires a municipal advisor, when it is within the scope of the advisory engagement and requested by a municipal entity or obligated person, to "undertake a thorough review of any recommendation made by any third party regarding a municipal securities transaction or municipal financial product." The advisor must also discuss with the client specific information concerning its evaluation.

Subsection (f), Principal Transactions

Subsection (f) would prohibit municipal advisors or their affiliates from engaging in principal transactions with a municipal entity or obligated person. An exception is provided for activities permitted by MSRB Rule G-23.

Subsection (g) Specified Prohibitions

This portion of the proposed rule lists five activities that municipal advisors are prohibited from engaging in. These activities are: receiving excessive compensation; delivering false invoices; making or submitting false or misleading representations; engaging in certain fee-splitting arrangements; and making payments to obtain or retain municipal advisory business except as permitted.

Subsection (h), Definitions

Subsection (h) of the rule defines the following terms: "advice," "affiliate of the municipal advisor," "municipal advisor," "municipal advisory activities," "municipal advisory relationship," "municipal advisory business," "municipal entity," "obligated person," and "official statement." To the extent there are definitions of these terms in the Securities Exchange Act of 1934 or rules thereunder or in other MSRB rules, the definitions in this rule refer to those definitions.

Miscellaneous Supplementary Material

The following provisions in the Supplementary Material do not relate to specific subsections of the rule but do relate to an advisor's standard of conduct under the rule.

.03, Action Independent or Contrary to Advice

This Supplementary Material provides that, if a municipal entity or obligated person elects a course of action that is independent of or contrary to the advisor's advice, the advisor is not required on that basis to disengage from the relationship.

.04, Limitations on the Scope of the Engagement

Supplementary Material .04 permits an advisor, if agreed to by the client, to limit the scope of its advisory relationship to certain specified activities or services, though it cannot alter the standards of conduct applicable to the relationship.

.06, Applicability of State or Other Laws

Supplementary Material .06 clarifies that nothing in the rule supersedes other provisions of state or other laws applicable to municipal advisors.

.10, College Savings Plans and Other Municipal Fund Securities

Supplementary Material .10 merely states that proposed Rule G-42 "applies equally to municipal advisors to sponsors or trustees of 529 college savings plans and other municipal fund securities." It provides no guidance regarding how some of the rule's requirements are to apply in the context of such plans other than to say the rule's reference to "official statement" includes the disclosure document for 529 college savings plans.

Jane G. Heinrichs
Senior Associate Counsel Tamara K. Salmon
Senior Associate Counsel

endnotes

[1] See Request for Comment on Draft MSRB Rule G-42, on Duties of Non-Solicitor Municipal Advisors, MSRB Notice No. 2014-01 (January 9, 2014) (the "Notice"), which is available at: http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2014-01.ashx?n=1.

[2] As discussed in the Notice, the rule would not apply to municipal advisors when undertaking a solicitation of a municipal entity or obligated persons. The MSRB intends to undertake a separate rule in the future that would govern solicitation activities. In the meantime, the MSRB's fair dealing rule, Rule G-17, would govern solicitors' activities. Notice at fn. 17. As used in this memo, the term "advisor" and "municipal advisor" do not include those solicitors that are excluded from the rule's scope.

[3] Notice at p. 7.

[4] No further guidance is provided regarding how these obligations would apply in connection with providing investment advice to municipal entities or working with them to structure 529 plans or their securities. For example, is the advisor required by its duty of

loyalty to “investigate or consider” competing products or plan structures that might be offered by competing firms?

[5] The rule does not appear to limit these disclosures to those that are applicable. Accordingly, it is uncertain whether this provision would require negative disclosure by those advisors that have some, but not all, of the conflicts required to be disclosed.

[6] See Notice at p. 9.; According to the Notice, “For example, if state law provided for the procurement of municipal advisory services in a manner that did not include a bilateral agreement, the municipal advisor could send a letter referencing the procurement document and containing the terms and disclosures” required by the rule. Notice at pp. 9-10.

[7] It is unclear how this provision would apply in the context of a municipal advisor advising a municipal entity on its 529 college savings plan program – e.g., what factors must the advisor consider in fulfilling a suitability requirement to the state in connection with a state’s 529 plan program?

[8] The Notice provides no discussion of how this Supplementary Material would apply in the context of 529 plans.
