Municipal Securities Rulemaking Board

August 12, 2015

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Response to Comments on SR-MSRB-2015-03

Dear Secretary:

On April 24, 2015, the Municipal Securities Rulemaking Board ("MSRB" or the "Board") filed with the Securities and Exchange Commission ("SEC") a proposed rule change consisting of proposed new MSRB Rule G-42, on duties of non-solicitor municipal advisors ("Proposed Rule G-42" or "proposed rule") and proposed amendments to MSRB Rule G-8, on books and records to be made by brokers, dealers, municipal securities dealers (collectively, "dealers"), and municipal advisors. The SEC published the proposed rule change for comment in the Federal Register on May 8, 2015.[1]

In developing the proposed rule change, the MSRB twice sought public comment regarding drafts of the proposed rule change. In response to the request for comment on the initial draft,[2] the MSRB received forty-six comment letters from a diverse group of commenters. After carefully considering the comments, the MSRB revised the draft proposal and sought further comment.[3] In response, the MSRB received nineteen additional comment letters. Many commenters expressed their appreciation that the MSRB had been responsive to their previous comments and concerns, based upon the MSRB's revisions of the initial draft proposal and the explanations of the decisions reflected in the revised draft. Some commenters, however, expressed some continuing or additional concerns regarding the revised draft proposal, which the MSRB addressed in the proposed rule change. Some commenters raised these same, or similar, issues in their comment letters to the SEC as previously raised regarding the proposed rule

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1 See Release No. 34-74860 (May 4, 2015), 80 FR 26752 (May 8, 2015) ("SEC Notice").

2 See MSRB Notice 2014-01 (January 9, 2014) ("Request for Comment on Draft MSRB Rule G-42, on Duties of Non-Solicitor Municipal Advisors") ("First Request for Comment").

3 See MSRB Notice 2014-12 (July 23, 2014) ("Request for Comment on Revised Draft MSRB Rule G-42, on Duties of Non-Solicitor Municipal Advisors") ("Second Request for Comment").

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change, while some raised new or different issues. In all, the SEC received fifteen comment letters on the proposed rule change.[4] This letter responds to those comments.

In addition, after carefully considering, and in response to, the comments, the MSRB is filing this day Amendment No. 1 to SR-MSRB-2015-03 ("Amendment No. 1") to make certain changes discussed below and other, minor amendments.

Standard of Conduct - Duty of Loyalty

SIFMA requested that the MSRB delimit more specifically the scope of the fiduciary duty owed by a municipal advisor to a municipal entity client by eliminating the phrases "includes, without limitation" in Proposed Rule G-42(a)(ii) and "includes, but is not limited to" in proposed paragraph .02 of the Supplementary Material. SIFMA stated that the addition of the "without limitation" language "raises significant and unnecessary ambiguities, as a fiduciary duty is generally understood to encompass a duty of care and duty of loyalty."

In response to the comment, the MSRB, in Amendment No. 1, is eliminating, in Proposed Rule G-42(a)(ii), the phrase ", without limitation," to address any ambiguity regarding the relationship between additional fiduciary duties and the specified duties of care and loyalty.[5] The

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4 See letters from Cristeena Naser, Vice President, Center for Securities, Trust & Investments, American Bankers Association ("ABA") dated May 29, 2015; Michael Nicholas, Chief Executive Officer, Bond Dealers of America ("BDA") dated May 29, 2015; Hill A. Feinberg, Chairman and Chief Executive Officer, and Michael Bartolotta, Vice Chairman, First Southwest Company ("First Southwest") dated May 29, 2015; David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute ("FSI") dated May 29, 2015; Dustin McDonald, Director, Federal Liaison Center, Government Finance Officers Association ("GFOA") dated May 22, 2015; Dustin McDonald, Director, Federal Liaison Center, GFOA, dated June 15, 2015; Guy E. Yandel, EVP & Head of Public Finance, et al., George K. Baum & Company ("GKB") dated May 29, 2015; Tamara K. Salmon, Associate General Counsel, Investment Company Institute ("ICI") dated May 29, 2015; Lindsey K. Bell, Millar Jiles, LLP ("Millar Jiles") dated May 29, 2015; Terri Heaton, President, National Association of Municipal Advisors ("NAMA") dated May 29, 2015; Leo Karwejna, Managing Director, Chief Compliance Officer, The PFM Group ("PFM") dated May 29, 2015; Leslie M. Norwood, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association ("SIFMA") dated May 28, 2015; Robert J. McCarthy, Director of Regulatory Policy, Wells Fargo Advisors LLC ("Wells Fargo") dated May 29, 2015; Joy A. Howard, WM Financial Strategies ("WM Financial") dated May 29, 2015; and W. David Hemingway, Executive Vice President, Zions First National Bank ("Zions") dated May 29, 2015. GFOA provided substantive comments in its letter dated June 15, 2015, and all references to GFOA's comments herein are to that letter.

5 The proposed amendment is set forth more specifically in Amendment No. 1.

MSRB, however, emphasizes the proposed amendment in no respect narrows or otherwise substantively modifies the scope of the fiduciary duty to which a municipal advisor would be subject under Proposed Rule G-42. Under Proposed Rule G-42(a)(ii), a municipal advisor is subject to a fiduciary duty that includes a duty of loyalty and a duty of care. It has been well established in the courts that the duty of loyalty requires one to act loyally for the benefit of one's principal in all matters connected with the relationship, and that this is a broad duty and standard, under which more specific duties have been articulated.[6] A fiduciary is also subject to a broad duty of care, which also includes more specific duties. The nature and scope of the term "fiduciary duty," including any duties and obligations that are subsumed within the duty of loyalty and the duty of care, have been shaped by the application of the component principles of what it means to have a fiduciary duty to the specific facts and circumstances of each given case, as interpreted by the courts in case law.

It has been the MSRB's intent from the inception of this rulemaking initiative not to purport to comprehensively set forth every aspect of the fiduciary duty that may be owed under the broad principle that Congress determined should apply to municipal advisors to municipal entity clients. Instead, Proposed Rule G-42 is designed primarily to set forth the core principles of the fiduciary duty that a municipal advisor would owe to its municipal entity client, and address and provide guidance on certain conduct that is likely to occur and issues that are likely to arise in the provision of municipal advisory services. For these reasons, the MSRB is not making the suggested deletion from proposed paragraph .02 of the Supplementary Material, which makes clear that the proposed rule is not an exhaustive statement of all aspects of the duty of loyalty. Although it is not possible for the MSRB to set forth every aspect of a fiduciary duty in Proposed Rule G-42 and the MSRB has not sought to do so, the MSRB nevertheless believes that the proposed rule change will provide municipal advisors with significant helpful guidance in understanding many aspects of their fiduciary duty and the conduct that is required of them.

Disclosure of Conflicts of Interest

Timing of Evidencing a Municipal Advisory Relationship and Conflicts Disclosures

NAMA, BDA and GKB suggested modifying the timing requirements of proposed Rule G-42(b), on disclosure of conflicts of interest and other information, so that it would align with the timing requirements of proposed section (c), on documentation of the municipal advisory relationship. NAMA also commented that proposed paragraphs (b)(i)(A) and (b)(i)(G), requiring similar disclosures, should be combined.

The MSRB previously considered and addressed the same or similar comments regarding the timing requirements of proposed sections (b) and (c).[7] After again considering the issues raised by the comments, the MSRB continues to believe that amendments to align the timing

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[6] See, e.g., Restatement (Third) of Agency, Section 8.01, Comment, part b.

[7] See 80 FR 26752, at 26769-26770.

requirements of proposed sections (b) and (c) would conflict with the intention of having municipal advisors disclose conflicts of interest prior to or at least upon engaging in municipal advisory activities for the municipal entity and obligated person clients. As discussed in the proposed rule change, modifying the timing requirement in proposed section (b) so that it mirrors proposed section (c) could cause municipal advisors to delay making the required disclosures until the municipal advisory relationship has been reduced to writing, which could be a significant amount of time after the client has received and considered, and potentially acted on, advice or recommendations from the municipal advisor.

However, the MSRB is proposing amendments to streamline the steps needed to comply with proposed sections (b) and (c).[8] First, the MSRB proposes that a municipal advisor would not be required to provide the disclosure of conflicts of interest and other information required under proposed subsection (c)(ii), if the municipal advisor previously fully complied with the requirements of section (b) to disclose such information and subsection (c)(ii) would not require the disclosure of any materially different information than that previously disclosed. The proposed amendment, to be incorporated in new proposed paragraph .06 of the Supplementary Material, would permit a municipal advisor to avoid making duplicative disclosures regarding its conflicts of interest and other matters. The proposed amendment also would include, as part of new proposed paragraph .06, the un-numbered paragraph previously located after subsection (c)(vii).[9] The MSRB believes that the material set forth in the un-numbered paragraph, which relates to updating and supplementing the relationship documentation, is more appropriately organized with the proposed amendment relating to proposed subsection (c)(ii) discussed above.

Second, in response to NAMA's comment, the MSRB proposes to combine the disclosures required under proposed paragraphs (b)(i)(A) and (b)(i)(G), as provided in new proposed paragraph (b)(i)(F) in Amendment No. 1.[10]

Contingent Fee Arrangements

WM Financial commented that, in its view, paragraph (b)(i)(F) of Proposed Rule G-42, which requires municipal advisors to disclose conflicts of interest arising from compensation arrangements that are contingent on the size or closing of any transaction as to which the municipal advisor is providing advice, should be deleted because a municipal advisor is

8 See 80 FR 26752, at 26762-26763.

9 The proposed amendments are set forth more specifically in Amendment No. 1. In connection with adding new proposed paragraph .06 of the Supplementary Material, Amendment No. 1 also will renumber proposed paragraphs .06 through .12 of the Supplementary Material as, respectively, proposed paragraphs .07 through .13.

10 Amendment No. 1 will delete proposed paragraph (b)(i)(A), and renumber proposed paragraphs (b)(i)(B) through (G) as, respectively, proposed paragraphs (b)(i)(A) through (F). The proposed amendments are set forth more specifically in Amendment No. 1.

"required to act in the best interest of [its] client . . . [and] good advice will prevent a fee arrangement from creating a [conflict]."

The MSRB considered a similar comment by WM Financial, and others, in response to previous requests for comment.[11] The MSRB does not endorse any particular compensation arrangement, and also has determined generally not to proscribe particular fee arrangements, such as contingent fee arrangements. However, the MSRB has determined that the proposed disclosure requirement regarding contingent fee arrangements is an appropriate and necessary measure to alert municipal entity and obligated person clients to the potential conflict of interest inherent in such fee arrangements, and believes proposed paragraph (b)(i)(F) will assist a municipal advisor's client in making an informed decision about any actual and potential conflicts of interests based on the relevant facts and circumstances. Also, as previously noted in the proposed rule change, municipal advisors would be free to provide a client with additional context about the benefits and drawbacks of a prospective type of fee arrangement, including in relation to alternative fee arrangements.[12]

Documentation of Municipal Advisory Relationship

Legal and Disciplinary Events on SEC Forms MA and MA-I

NAMA supported requiring a municipal advisor to provide a client information regarding any legal or disciplinary event that is material to the client's evaluation of the municipal advisor or the integrity of its management or advisory personnel and permitting municipal advisors to comply with the disclosure requirements by referring the client to Forms MA and MA-I, but stated that clients will find it very difficult or burdensome to find the relevant MA-I documents. GFOA expressed a similar concern that a client would find it burdensome to locate Forms MA and MA-I within the SEC's EDGAR system and requested that Proposed Rule G-42(c) be amended to require a municipal advisor to deliver copies of the Forms MA-I (and presumably Form MA) as part of the written documentation required to be delivered to the client. GFOA also suggested modifying proposed subsection (c)(iv) to require a municipal advisor to provide a client with more information than the date of the last material change or addition to the legal or

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11 See comment letters submitted by Lewis Young Robertson & Burningham, Inc. and Cooperman Associates in response to the First Request for Comment, and comment letters submitted by Columbia Capital Management, LLC and Piper Jaffray in response to the Second Request for Comment. See also 80 FR 26752, at 26764-26765 (MSRB discussed, and responded to, the same or substantially similar comments).

12 Although the MSRB, in the proposed rule change, indicated a general intention to reduce the occurrence of conflicts of interest, the MSRB reiterates that Proposed Rule G-42 is not intended to prohibit the use of contingent fee arrangements, recognizing that contingent fee arrangements may be potentially beneficial to certain clients. At the same time, the MSRB believes it is appropriate to require that all related actual and potential material conflicts be fully and fairly disclosed when a contingent fee arrangement is used.

disciplinary event disclosures on any Form MA or Form MA-I filed with the SEC. GFOA suggested requiring a municipal advisor to notify its client when material changes are made to its forms, provide the client the modified form and provide the client a brief explanation of how the changes materially pertain to the nature of the relationship between the municipal advisor and its client. GFOA believes that, with the suggested modification, issuers would receive the disclosures that affect them directly, rather than receiving numerous notifications about changes to lengthy documents that may not be material.

It is important to note that, although Proposed Rule G-42(c)(ii) requires a municipal advisor, by incorporating the requirements under proposed section (b), to disclose any legal or disciplinary event that is material to the client's evaluation of the municipal advisor, the provision in proposed section (b) allowing the municipal advisor to provide such information by identifying the specific type of event and specific reference to the relevant portions of the municipal advisor's most recent Forms MA or MA-I (and, if doing so, providing detailed information specifying where the client may electronically access such forms) is permissive, not mandatory. In any event, based on careful consideration of the comments, the MSRB believes that it would be appropriate and beneficial for a municipal advisor, at the time of making the disclosures under proposed subsections (c)(iii) and (c)(iv), to provide the client not only the date of the last material change or addition to the legal or disciplinary event disclosures on any Form MA or Form MA-I, but also to provide a brief explanation of the basis for the materiality of each change or addition. This explanation would allow a municipal advisor client to assess the effect that such changes may have on the municipal advisory relationship and evaluate whether it should seek or review additional information.[13] However, because a municipal advisor is required by the SEC to publicly disclose such information to the SEC, the MSRB does not believe that it is appropriate or necessary to require a municipal advisor thereafter to make the specific disclosures again to every client.

NAMA also asked that the MSRB provide more clarity regarding the requirement in proposed subsection (c)(iii) that the municipal advisor provide "detailed information specifying where the client may electronically access the municipal advisor's most recent Form MA and each most recent Form MA-I filed with the Commission." In response to the comment, the MSRB states that a municipal advisor would be able to satisfy this aspect of its disclosure obligation by, for example, providing its client with a functioning Uniform Resource Locator ("URL") (also referred to as a web address or a link) to the municipal advisor's most recent Form MA or MA-I filed with the SEC through the EDGAR system. This is, however, only an example and does not preclude other methods of compliance.[14]

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[13] The proposed amendment to Proposed Rule G-42(c)(iv) is set forth more specifically in Amendment No. 1.

[14] The MSRB stated, as part of the proposed rule change, that a municipal advisor could alternatively meet this requirement by publishing its most recent forms on its own website and then providing the client with the direct URL to the forms. See 80 FR 26752, at 26754-26755.

Recommendations and Review of Recommendations of Other Parties

Recordkeeping Requirement for Reviews of Recommendations by Other Parties

BDA and First Southwest stated that the proposed recordkeeping requirements of proposed Rule G-8(h)(iv) are overly prescriptive and would require a municipal advisor to unnecessarily dedicate significant time and resources to comply with the proposed amendments without a corresponding benefit to its clients. Both commenters believed that the specificity of the requirements would hinder the flexibility that municipal advisors need to adequately serve their clients. First Southwest commented that the advice given to a client will be diluted if a municipal advisor is required to inform its client of "a laundry list of consequences."[15] NAMA requested the MSRB to provide additional clarity regarding how a municipal advisor should document its review of a recommendation or basis for its own recommendation and include explicit examples and interpretive guidance.

As discussed in the proposed rule change,[16] the MSRB believes that the documentation required by proposed Rule G-8(h)(iv) is an appropriately tailored recordkeeping requirement that will assist regulatory examiners in assessing the compliance of municipal advisors with Proposed Rule G-42. Also, the MSRB believes the recordkeeping requirements will not be overly burdensome because municipal advisors would be required to maintain only the documents created by the municipal advisor that were material to its review of a recommendation by another party or that memorialize the basis for any conclusions as to suitability.

Informing the Municipal Advisor's Client Regarding Its Recommendations

NAMA stated that, while supportive of the requirement to inform clients about reasons for a recommendation or non-recommendation, the proposed rule should provide a "non-exclusive list of examples...of how regulated entities could comply with the regulations." Similarly, PFM commented that the MSRB should provide a more concise definition of the term "suitable" to enable municipal advisors to comply with the provision.

Through Proposed Rule G-42, the MSRB proposes to provide guidance by articulating principles and prescribing certain conduct regarding a municipal advisor's communications with

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15 In its comment, First Southwest stated its concern that a "pay-to-play" rule for non-dealer municipal advisors is not yet in effect. The comment relates to a separate MSRB rulemaking initiative to amend MSRB Rule G-37, regarding "pay-to-play" issues, to extend its provisions to municipal advisors. At such time as the MSRB submits the proposed rule change regarding the amendments to Rule G-37 to the SEC, commenters may submit comments on that matter, which then will be reviewed and responded to as appropriate by the MSRB.

16 80 FR 26752, at 26773 (MSRB discussed, and responded to, the same or substantially similar comments).

its client of its recommendations and reviews of recommendations of other parties, primarily in proposed subsections (d)(i)-(iii) and proposed paragraphs .01, .08 and .09 of the Supplementary Material. (Proposed paragraphs .08 and .09 are renumbered in Amendment No. 1, and hereinafter referred to, as, respectively, proposed paragraphs .09 and .10 of the Supplementary Material.) This includes guidance regarding what information to consider when forming advice or a recommendation. The MSRB believes that incorporating a more prescriptive or descriptive approach to determining suitability in the proposed rule would risk creating inflexible requirements that would fail to adequately account for the diversity of municipal advisors, the municipal advisory activities in which they engage and the varying needs of clients.

NAMA also requested additional guidance on proposed subsection (d)(iii), regarding informing a municipal advisor's client whether the municipal advisor investigated or considered reasonably feasible alternatives because NAMA was concerned that a municipal advisor would be required to provide a voluminous list of possible alternative financings that may not be germane to the client. NAMA suggested modifying proposed subsection (d)(iii) to read "other suitable and reasonably feasible alternatives" to "better reflect the suitability standard" of Proposed Rule G-42.

Proposed subsection (d)(iii) would require a municipal advisor to inform its client whether or not it considered other reasonably feasible alternatives to the recommendation it made to its client that might also or alternatively serve the client's objectives. This language would not require a municipal advisor to provide its client with an exhaustive list of "alternative financings" together with its recommendation (particularly if such alternative financings are not germane to the client). The provision also would not require the municipal advisor to conduct a suitability analysis on any "reasonably feasible alternative" considered or investigated by the municipal advisor. The municipal advisor would be obligated under proposed subsection (d)(ii) only to inform its clients whether or not it considered or investigated reasonably feasible alternatives. The decision of whether to have the municipal advisor discuss the alternatives it considered or investigated would be left to the discretion of the municipal advisor and its client and their determination together of the scope of the municipal advisory engagement.

Recommendations, Duty of Care and Reasonable Investigations of Material Information

ICI, GFOA, SIFMA and WM Financial commented that it would be unreasonable and overly burdensome to require municipal advisors to undertake a reasonable investigation to determine that it is not basing any of its recommendations on materially inaccurate or incomplete information when the client provided such information. ICI stated that it is worried that the proposed rule change will require municipal advisors to investigate information that a municipal advisor may not have the access, or the authority, necessary to assess its accuracy and completeness. SIFMA added that this requirement is inconsistent with "standards applicable to broker-dealers and investment advisers" because neither "are required to challenge the statements of their clients." WM Financial, while supporting the requirement that a municipal advisor should make a reasonable investigation into the facts underlying its recommendation, believes that a municipal advisor's investigation also should include relevant and publicly

available documentation and discussions with its client. WM Financial, however, concurred with SIFMA, GFOA and ICI and stated that a municipal advisor should be permitted to assume that information that is beyond what is publicly available and is provided by its client is complete and accurate. In a related comment, NAMA requested that the MSRB provide greater clarity by providing "non-exclusive explanatory examples of what constitutes 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.'"

The MSRB received similar comments during the development of Proposed Rule G-42 and believes that the response to those comments in the proposed rule change sufficiently addresses the comments submitted by SIFMA, GFOA, ICI and WM Financial.[17] The MSRB determined that a municipal advisor should be required to conduct a reasonable investigation of the accuracy and completeness of the information on which it is basing its recommendation and that the requirement will not likely result in an unreasonable and unnecessary burden for municipal advisors or their clients. Under the proposed rule, municipal advisors would not be required to go to the impractical lengths suggested by some commenters. If the information necessary to determine whether a municipal advisor is basing its recommendation on materially inaccurate or incomplete information is non-public, entirely created or controlled by the client or is otherwise not accessible through a reasonable amount of effort by the municipal advisor, then, in such instances, the determination of what would constitute a reasonable investigation would be reflective of those and other relevant facts and circumstances.

Recommendations and Review of Recommendation of Other Parties - Suitability

GFOA expressed concern that proposed subsection (d)(ii) implies that a municipal advisor would be permitted to make a recommendation to its client that the municipal advisor determined was unsuitable, and requested that the MSRB clarify the matter. Currently, the proposed rule would prohibit a municipal advisor from making recommendations to its clients that do not comport with the suitability standards of the proposed rule. The specific rule language of subsection (d)(ii) that GFOA expressed concern about is only applicable to a municipal advisor's review of a recommendation of another party. In its review of a recommendation of another party, the proposed rule would require the municipal advisor to inform its client of the basis upon which a recommendation provided by that other party is, or is not, suitable. To clarify the distinction in section (d) between recommendations of the municipal advisor and the municipal advisor's review of recommendations of others, the MSRB is making two amendments.[18] First, the MSRB is amending section (d) to state that a municipal advisor making a recommendation must have a reasonable basis to believe that the recommended municipal securities transaction or municipal financial product is suitable for the client. Second, the MSRB is amending subsection (d)(ii) to provide that the requirement to inform the client that a

17 80 FR 26752, at 26763, 26773-26774 and 26783-26784 (MSRB discussed, and responded to, the same or substantially similar comments).

18 The proposed amendment is set forth more specifically in Amendment No. 1.

recommendation is unsuitable potentially arises only in the context of the review of a recommendation of another.

Inadvertent Advice Exemption

SIFMA requested broadening the limited safe harbor under proposed paragraph .06 of the Supplementary Material to relieve municipal advisors that inadvertently engage in municipal advisory activities from compliance with proposed section (d), on recommendations and reviews of recommendations of other parties, and proposed subsection (e)(ii), on specifically prohibited principal transactions. (Proposed paragraph .06 is renumbered in Amendment No. 1, and hereinafter referred to, as proposed paragraph .07 of the Supplementary Material.) SIFMA stated that a firm would be unlikely to rely on the safe harbor provision unless it is broadened to include an exemption from the prohibition on principal transactions.

SIFMA originally requested this modification in a response to a previous request for comment and the MSRB continues to believe that, despite having engaged in municipal advisory activities inadvertently, a municipal advisor should not be relieved of complying with these provisions.[19] Proposed section (d) applies only in the case where a municipal advisor makes a recommendation of a municipal securities transactions or municipal financial product, or, where within the scope of the engagement and at the client's request, the municipal advisor reviews a recommendation of a third party. The MSRB believes that these limitations will address SIFMA's concerns to some degree. In addition, the MSRB attaches weight to the several commenters that previously expressed concern that, if the safe harbor were to relieve municipal advisors from compliance with proposed subsection (e)(ii), the provision might be misinterpreted or misused in a manner contrary to the purposes of the SEC's registration regime and the fiduciary duty owed to municipal entity clients.[20]

Prohibition on Delivering Inaccurate Invoices

SIFMA commented that Proposed Rule G-42(e)(i)(B), which would prohibit municipal advisors from delivering an invoice for fees or expenses for municipal advisory activities that does not accurately reflect the activities actually performed or the personnel who actually performed such activities, should be retained, but qualified, requiring, for a violation, that the municipal advisor must have intentionally delivered a materially inaccurate invoice.[21]

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[19] See comments submitted by SIFMA in response to the Second Request for Comment. See also 80 FR 26752, at 26783-26784 (MSRB discussed, and responded to, the same or a substantially similar comment).

[20] See comments submitted by NAIPFA and WM Financial in response to the Second Request for Comment. See also 80 FR 26752, at 26783-26784.

[21] See similar comments submitted by SIFMA in response to the First Request for Comment. See also 80 FR 26752, at 26777.

The MSRB believes that SIFMA's comment regarding materiality, which suggests that materiality as to any errors in an invoice should be an element of a violation of Proposed Rule G-42(e)(i)(B), is an appropriate limitation of the provision. The MSRB proposes to modify Proposed Rule G-42(e)(i)(B) accordingly to prohibit "delivering an invoice . . . for municipal advisory activities that is materially inaccurate in its reflection of the activities actually performed or the personnel that actually performed those activities," and to delete the words, "do not accurately reflect" within the same provision. The proposed amendment would make explicit that, as previously stated, the proposed prohibition is intended to target any inaccuracies in connection with the significant subjects of the services performed and the personnel who performed those services.[22] Although the MSRB declines also to add a state-of-mind requirement as SIFMA requested, the MSRB believes that the proposed amendment will address the type of billing errors about which SIFMA expressed concern. In addition, the MSRB believes that a provision with the state-of-mind elements that SIFMA suggested would not sufficiently protect municipal entity and obligated person clients.

Prohibited Principal Transactions

Several commenters addressed Proposed Rule G-42(e)(ii), which would prohibit a municipal advisor to a municipal entity client, and any affiliate of such municipal advisor, from engaging in a principal transaction directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing or has provided advice. The comments from the ABA, BDA, FSI, GFOA, GKB, Millar Jiles, NAMA, SIFMA, Wells Fargo and Zions covered a range of issues, as discussed below. Several of the commenters had submitted similar comments previously regarding the proposed prohibition on principal transactions.

Comparison with Similar Regulatory Regimes

SIFMA and Zions commented that a prohibition on principal transactions is inconsistent with other fiduciary-duty regimes, including that applicable to investment advisers, which rely upon various disclosures (e.g., of capacity, compensation and other relevant facts) and client consent to permit certain principal transactions. SIFMA and Zions previously filed similar comments regarding prior iterations of Proposed Rule G-42.[23] FSI commented that the MSRB should consider creating an exception for principal transactions similar to SEC's temporary rule

22 See 80 FR 26752, at 26777. The proposed amendment is set forth more specifically in Amendment No. 1.

23 See SIFMA comments, p. 4, n. 5 (referencing comments filed by SIFMA in response to the First and Second Requests for Comment); and Zions's comments filed in response to the Second Request for Comment.

authorizing principal trades with non-discretionary advisory clients for entities dually registered as a broker-dealer and an investment adviser.[24]

The MSRB previously considered such comments, analyzing the fiduciary duty of the municipal advisor in its relationship to a municipal entity client and the possibility for self-dealing and determined, after careful consideration of the views of commenters, that the proposed prohibition on principal transactions is sufficiently targeted and should not be amended to include exceptions based on disclosure and client consent.[25] The MSRB does not find sufficient additional rationale offered in the most recent commentary to revise the provision in the manner suggested. The MSRB continues to believe that incorporating such exceptions to the prohibition on principal transactions would not sufficiently protect municipal entity clients from potential self-dealing-related abuses.

Exception for Advice Incidental to Securities Execution Services

Several commenters, including FSI, GFOA and SIFMA, stated that the MSRB should consider an exception to the prohibition on principal transactions, when advice is provided to a municipal entity client that is incidental or ancillary to a broker-dealer's execution of securities transactions, including transactions involving municipal bond proceeds or municipal escrow funds. FSI suggested an exception, which would include certain disclosure and consent provisions, similar to a temporary rule adopted by the SEC that permits investment advisers that are also broker-dealers to act in a principal capacity in transactions with certain advisory clients ("SEC Temporary Rule").[26] FSI also commented that, if an exception were created, it should be limited to transactions in certain debt securities, as defined in SEC Rule 10b-10(d)(4)[27] and FINRA debt transaction reporting rules, which securities FSI believed were widely held, maintained a sufficient amount of liquidity and transparency, and posed a lower degree of risk to investors. Finally, FSI noted it sought only an exception from the prohibition on principal transactions, and was not seeking an exception from its fiduciary duty or the definition of municipal advisor. Alternatively, SIFMA suggested that the MSRB consider temporarily excluding from the proposed prohibition sales of fixed income securities by a broker-dealer

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24 SEC Temporary Rule 206(3)-3T (17 CFR 275.206(3)-3T) promulgated pursuant to the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) ("SEC Temporary Rule").

25 See 80 FR 26752, at 26780-26781 (MSRB discussed, and responded to, the same or substantially similar comments).

26 See Rule 206(3)-3T (17 CFR 275.206(3)-3T) under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.). According to FSI, FSI members generally are not also in investment advisory relationships with their municipal entity clients because the needs of municipal entity clients do not lend themselves to being in traditional fee-based investment advisory relationships.

27 17 CFR 240.10b-10(d)(4).

providing incidental advice, including on bond proceeds, to the transaction, until the SEC and the Department of Labor ("DOL") conclude their ongoing consideration of a uniform fiduciary standard for broker-dealers and investment advisers, and then harmonize the MSRB's regulatory approach to the execution of fixed income transactions when a fiduciary duty is owed to the client. GFOA expressed concern that the proposed prohibition could force small governments to establish "a more expensive fee-based arrangement with an investment advisor in order to receive this very limited type of advice."

In the release adopting the SEC Final Rule defining "municipal advisor" and other key terms and setting forth registration requirements for municipal advisors, the SEC considered a number of comments requesting that broker-dealers be exempted from the municipal advisor registration requirements for a broker-dealer that engages in municipal advisory activities that are solely incidental to the conduct of its business as a broker-dealer. [28] The Commission concluded that a registered broker-dealer that engages in municipal advisory activities by advising on the investment of proceeds of municipal securities or municipal escrow investments should not be exempt from municipal advisor registration, including when such activities were incidental or ancillary to a transaction.[29] Moreover, providing an exemption from registration as a municipal advisor for broker-dealers providing advice solely incidental to a transaction would have been inconsistent with the Commission's view that the sale of a security to a municipal entity (or an obligated person) constitutes municipal advisory activity if the monies are proceeds of municipal securities, and in executing such transaction, the broker-dealer also recommends the investment or otherwise offers advice to the municipal entity (or obligated person) about which securities to sell. In reaching these conclusions, among other things, the SEC noted that "municipal entities suffered significant losses in the financial crisis related to advice . . . on investments, such as refunding escrow investments provided by underwriters,"[30] and cited a "notable historic example" of pricing abuses, where a large number of major broker-dealers charged artificially high prices in the sale of U.S. Treasury securities to municipal entities to fund municipal escrow investments.[31]

After carefully considering the comments and the SEC's prior consideration of an exemption, based on similar activity, from registration as a municipal advisor, and the need to protect municipal entities from self-dealing and conflicts of interest arising in such transactions,

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28 See Registration of Municipal Advisors, Release No. 34-70462 (Sept. 20, 2013), 78 FR 67467, at 67515-67516 (Nov. 12, 2013) (adopting SEC Rules 15Ba1-1 through 15Ba1-8 (17 CFR 240.15Ba1-1 through 17 CFR 240.15Ba1-8)) ("release adopting SEC Final Rule").

29 Id.

30 Release adopting SEC Final Rule, 78 FR 67468, at 67512.

31 Release adopting SEC Final Rule, 78 FR 67468, at 67496 (discussing the practice of "yield-burning").

the MSRB continues to believe that the prohibition is appropriately targeted and should not be modified at this juncture to include an exception for principal transactions of the type suggested. Moreover, the MSRB believes such an exemption would be inappropriate to adopt on a temporary basis, until such time as the SEC and DOL conclude their ongoing consideration of a uniform fiduciary standard that may apply to broker-dealers and investment advisers, as suggested by SIFMA. The MSRB does not believe that it is appropriate to delay adopting a standard of conduct regarding prohibited principal transactions, given the mandate for the MSRB to adopt a regulatory framework for the regulation of municipal advisors, and the need to implement Proposed Rule G-42 and provide regulatory certainty at this time. The proposed provision aligns with the fiduciary duty standard required under Dodd-Frank and affords municipal entities certain protections from potential self-dealing related abuses by a fiduciary also acting as a counterparty.

In response to GFOA's comment that the proposed prohibition could force small governments to establish "a more expensive fee-based arrangement with an investment advisor in order to receive this very limited type of advice," the MSRB believes at this time that the potential benefits provided to municipal entities, which may receive more focused, expert and unbiased advice and possibly more favorable transaction executions, will outweigh the costs. The prohibition is proposed in the context of municipal entities that previously were subject to costs by conflicted persons providing financial advice and also acting as counterparties in the same or related transactions. If the proposed prohibition is in place, a municipal entity may either enter into a fee-based relationship or utilize the services of an independent broker-dealer to execute trades. Under the latter scenario, the MSRB expects that both the market for municipal advisory services and the market for execution services will be competitive. Thus, although it is possible that municipal entities may be required in some instances to hire a financial professional in addition to establishing a relationship with a broker-dealer for execution services, on balance, the MSRB believes at this time that the potential benefits outweigh the potential costs.

SIFMA also commented that the MSRB should reconsider in detail how, if at all, the requirements of Proposed Rule G-42 (e.g., the disclosures under proposed section (b) and the documentation under proposed section (c)) generally should be applied in the brokerage and execution context, given, in SIFMA's view, that the brokerage relationship is qualitatively different from other activities in which the municipal advisor engages. It is important to note that the requirements of the proposed rule, including proposed sections (b) and (c) specified by SIFMA, apply if the actor at issue is engaging in municipal advisory activities. The MSRB does not find sufficiently persuasive support in the commentary indicating why municipal advisory activities provided in the context of a brokerage relationship differ qualitatively from other municipal advisory activities. Thus, the MSRB does not believe it is necessary or appropriate at this time to distinguish this municipal advisory activity, and the application of the proposed rule to this activity, from other municipal advisory activities.

Scope: "Directly Related To"

BDA commented that the prohibition against principal transactions is vague and open to interpretation due to the use of the phrase "directly related to," raising a concern expressed in its prior comment letter. GKB concurred with BDA's comment. BDA and SIFMA also suggested alternative text, as in their prior comment letters, to narrow or clarify the scope of the prohibited principal transaction provision.[32] Finally, BDA requested clarification regarding the application of the provision to specific scenarios and SIFMA requested clarification regarding when a ban would end.

The MSRB previously considered and addressed numerous comments regarding the scope of the principal transaction prohibition, including those referenced above. The MSRB does not find significant additional rationale in the most recent commentary to support incorporating the revisions suggested by the commenters, and the MSRB continues to believe that it is not appropriate to narrow, broaden or otherwise modify the standard in response to these comments. The alternatives suggested by commenters would seek to limit the scope of prohibited transactions to those pertaining to the advice rendered by the municipal advisor, which the MSRB concluded previously could leave transactions that have a high risk of self-dealing unaddressed, as illustrated by an example provided by the MSRB in the proposed rule change. In response to the request that the MSRB clarify when a ban would end, however, the MSRB believes, generally like SIFMA, that the passage of time is a relevant factor in determining whether a principal transaction is "directly related" to a transaction as to which the municipal advisor has provided advice. However, the MSRB does not believe it would be feasible or desirable to specify in advance how much elapsed time would make the proposed prohibition inapplicable in all circumstances, given the principled nature of the provision.[33]

Exception for Affiliates or "Remote Businesses"

SIFMA and Wells Fargo renewed their prior comments and opposed the scope of the prohibition on principal transactions covering affiliates of the municipal advisor, and, in the case of SIFMA, also to certain business departments or businesses within the same entity as the municipal adviser that SIFMA defined, collectively with affiliates, as "Remote Businesses."[34]

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32 See BDA and SIFMA comments filed in response to the Second Request for Comment. See also 80 FR 26752, at 26779, n. 73, 26780 (MSRB discussed, and responded to, the same or substantially similar comments).

33 See 80 FR 26752, at 26780.

34 SIFMA and Wells Fargo were among the persons commenting in response to both the First and Second Requests for Comment regarding this issue. See 80 FR 26752, 26781-26782 (MSRB discussed, and responded to, the same or substantially similar comments). SIFMA defined "Remote Businesses" as the areas of a municipal advisor and its affiliates that have no knowledge of the advisory engagement, or its scope and where the

Both commenters expressed concern regarding the potential impact of the proposed prohibition on principal transactions, as extended to affiliates and departments or businesses, to large financial institutions. Wells Fargo commented again that the MSRB should exempt municipal advisor affiliates operating with information barriers, and stated that, if an affiliate has no actual knowledge of the municipal advisory relationship between the municipal entity client and the municipal advisor due to information barriers and governance structures, the risk of a conflict of interest is significantly diminished. SIFMA also again requested the MSRB to modify the prohibition to add a knowledge standard (i.e., to prohibit a municipal advisor and any affiliate from knowingly engaging in a prohibited principal transaction).

The MSRB does not find sufficient additional rationale in the most recent commentary to support the revisions suggested by the commenters, and the issues raised by the commenters are substantially similar to the comments previously discussed in the proposed rule change.[35] After considering the comments carefully, the fiduciary duty of the municipal advisor in its relationship to a municipal entity client, and the risk of self-dealing, the MSRB continues to believe that the proposed prohibition on principal transactions as to affiliates (and departments and businesses within the same legal entity as the municipal advisor) is appropriately targeted. In the MSRB's view, the proposed prohibition should be retained without the suggested exception, given the acute nature of the conflicts of interests presented and the risks of self-dealing by affiliates in transactions that are "directly related" to the same municipal securities transaction or municipal financial product as to which the affiliated municipal advisor is providing or has provided advice. Also, if the prohibition on principal transactions as it applies to affiliates or departments or businesses within the same legal entity were modified by "knowingly" as suggested by the commenters, the MSRB believes that the standard would be overly stringent, which could hinder regulatory examinations and enforcement.

Bank Loans

Several comments were received regarding proposed paragraph .11 of the Supplementary Material (renumbered in Amendment No. 1, and hereinafter referred to, as proposed paragraph .12 of the Supplementary Material), under which a bank loan would be, if "in an aggregate principal amount of $1,000,000 or more and economically equivalent to the purchase of one or more municipal securities," an "other similar financial product" for purposes of the prohibition on principal transactions.[36]

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municipal advisory business: (i) has not advised, directed or encouraged the municipal entity to engage in the principal transaction with such other area or affiliate and (ii) has no direct economic interest in any such principal transaction.

35 See 80 FR 26752, at 26781-26782 (MSRB discussed, and responded to, the same or substantially similar comments).

36 In Amendment No. 1, proposed paragraph .11 of the Supplementary Material will be renumbered as proposed paragraph .12. Amendment No. 1 also will include proposed

In connection with bank loans entered into with a municipal entity by a bank that is an affiliate of a municipal advisor, the ABA requested that the MSRB modify proposed paragraph .12 to exclude bank loans made by an affiliate from the definition of "other similar financial products" if the bank enters into the loan after the municipal entity solicits bidders for such loan using a request for proposal ("RFP"), which ABA characterized as a "neutral process," and the bank intends to hold the loan on its books until maturity. In the ABA's view, if an RFP process is used, there should be few concerns regarding conflicts if a loan is entered into by an affiliate of a municipal advisor to a municipal entity and, if the provision were so amended, a municipal entity would be free to choose its lender based on the factors most appropriate for the municipality and its taxpayers. Similarly, Millar Jiles suggested that a municipal advisor should be able to satisfy its fiduciary obligation to a municipal entity by procuring bids for the proposed financing (and thus make a principal bank loan transaction through an affiliated entity permissible), stating that, if the affiliate of the municipal advisor were the lowest bidder, the municipality would be penalized by being forced to borrow at a higher rate under the rule as currently proposed. ABA stated that the potential conflicts of interest also should be substantially mitigated if a bank holds a loan on its books until maturity, because, ABA states, in such cases, the interests of the municipal entity and bank are aligned in that each party wants funding that serves the particular needs of the municipal entity, and the lender and borrower both must be satisfied that the loan can be repaid and desire that it be repaid.

The MSRB believes that, even if both elements (i.e., the use of an RFP and intent to hold a loan to maturity) were incorporated as conditions to exclude certain principal transactions from the prohibition in Proposed Rule G-42(e)(ii), the conflicts of interest are not sufficiently mitigated to eliminate the concerns of overreaching and self-dealing and other actions inconsistent with the fiduciary duty between the municipal advisor and its client. That a bank and its borrower may be aligned in wanting a loan to be repaid does not alter the fact that the bank and the borrower are counterparties, with conflicting interests in other respects. Moreover, the MSRB believes that a lender's intent at one point in time to hold a loan on its books until maturity would provide insufficient controls or checks over conflicts of interest inherent in the transaction. The MSRB notes that, at any time after making the loan, a bank would be free to change its intent and sell the loan if doing so was in the bank's best interest. Finally, an RFP process does not protect a municipal entity sufficiently from conflicts of interest. A municipal advisor may, for example, be able to inappropriately influence the municipal entity client to obtain a loan instead of issuing a municipal security, or to influence the RFP process or requirements to favor the selection of the municipal advisor's bank affiliate as lender.

BDA commented that the definition of a bank loan as an "other similar financial product" is ambiguous and lacks clarity, and that the apparent purpose of the language, "economically equivalent to the purchase of one or more municipal securities," is to develop a standard that does not depend on determining when a bank loan constitutes a municipal security. The BDA

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minor technical amendments to proposed subsection (f)(i), defining a principal transaction, as more specifically set forth therein.

then noted the difficulty in applying the Reves test[37] to determine when a bank loan is considered a security. BDA suggested that the MSRB should use five structural components that are used by market participants to differentiate a conventional bank loan from "direct purchase products -- ratings, CUSIP, certificated bonds, transfer provisions and DTC registration –" and state clearly exactly which features of a direct purchase structure would cause it to fall within the definition of "other similar financial product."

According to the terms of proposed paragraph .12 of the Supplementary Material, not all loans of $1 million or more would be considered an "other similar financial product." The MSRB believes that the identification of a bank loan as an "other similar financial product" would depend on the facts and circumstances regarding a particular loan, including structure and marketing. Finally, the MSRB notes in response to a comment regarding use of the test in Reves, that using the Reves test to determine whether a bank loan is a security would not be the appropriate test under proposed paragraph .12 to determine whether a bank loan is considered an "other similar financial product," because the defined term is drafted intentionally to include bank loans other than those that are a security.

Millar Jiles asked whether loans would be aggregated to reach the $1 million threshold, and, if so, based on what factors. Regarding the interpretation of the phrase "economically equivalent to the purchase of one or more municipal securities," Millar Jiles noted that the typical bank loan to a municipal entity is payable over a term of less than five years and is for the purchase of equipment. Millar Jiles stated that the typical municipal security is secured by a pledge of revenues and is payable over a much longer term, and asked whether a bank loan of $1.5 million, which is secured by real or personal property and payable over a term of five year or less, would be considered economically equivalent to the purchase of one or more municipal securities.

The MSRB believes that whether one or more loans would be aggregated to reach the $1 million threshold would depend on the particular facts and circumstances surrounding the transactions, including, but not limited to, factors such as how close in time to the other the loans occurred, the purpose of each loan and the similarity of purpose among the loans, and whether such loans are components of a more comprehensive plan of financing. Further, no single factor, such as size (apart from the $1 million threshold), or the nature of the security provided in the financing, would be determinative in such an analysis. For example, in its comments, Millar Jiles asked if aggregation would occur if a municipality borrowed $600,000 to purchase new garbage trucks, and, a year later, in a separate loan, the municipality borrowed $500,000 to purchase new fire trucks. In the MSRB's view, absent other factors evidencing a similarity of purpose or that the loans were components of a single, more comprehensive plan of financing, such loans would not be aggregated, because the borrowings did not occur close in time and were made for two distinct purposes – to acquire garbage trucks, and, subsequently, to acquire fire trucks.

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[37] The commenter refers to a list of factors to consider in determining if an instrument denominated as a "note" is a security, as set forth in Reves v. Ernst & Young, 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990).

Zions commented that bank loans should be not be considered an "other similar financial product" under proposed paragraph .12 of the Supplementary Material, but if they were so characterized, the MSRB should raise the threshold from $1 million to $10 million. Zions stated that proposed paragraph .12, if adopted, would be inconsistent conceptually with the current bank regulatory scheme, noting that current regulations allow individuals and private businesses to borrow money from the same bank that serves as their fiduciary, but proposed paragraph .12 would prohibit municipal entities from borrowing from such institutions, implying that municipal entities do not have the financial acumen to borrow from institutions that also serve as their fiduciaries. Zions also commented that many of the direct loans to smaller and more remote municipal entities for which Zions also serves as financial advisor qualify for Community Reinvestment Act ("CRA") credit from its banking regulators,[38] and any rule that would have the tendency to force banks to provide services to underserviced municipalities in less than all three of the required categories (i.e., lending, investments and financial services) would run counter to Congress's intent under the CRA to foster and require banks to provide the three types of services to such under-served municipalities and communities.

In response to Zions's comment that bank loans should be excluded, the MSRB notes that proposed paragraph .12 is limited substantially and would target only those loans that would be the same as, or directly related to, the municipal securities transaction or municipal financial product as to which the municipal advisor is providing or has provided advice and which would be considered "economically equivalent to the purchase of one or more municipal securities."

In response to comments regarding increasing the threshold from $1 million to $10 million, the MSRB believes that, at this juncture, the proposed threshold of $1 million should be retained.[39] After the MSRB has experience with the rule as in effect, the MSRB may solicit information regarding whether the proposed threshold of $1 million should be modified.

In response to Zions's comments regarding a bank's obligation to provide loans, investments and financial services to under-served individuals and communities under the CRA, the MSRB notes that the proposed prohibition on principal transactions is narrowly targeted and would have a limited impact on a municipal advisor or its affiliate providing loans and financial services, generally. The proposed prohibition would apply solely to a principal transaction that is the same, or is directly related to the, municipal securities transaction or municipal financial product as to which the municipal advisor is providing or has provided advice to the municipal entity client. In addition, the proposed prohibition would only apply to a bank loan of $1 million or more that is economically equivalent to the purchase of one or more municipal securities.

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38 12 U.S.C. 2901 et seq.

39 One million dollars, the proposed threshold for bank loans that may be "other similar financial products" for purposes of the prohibition on principal transactions, is used in other aspects of the regulation of the municipal securities market as a threshold above which additional regulatory requirements are appropriately applied. See SEC Rule 15c2-12(a) (17 CFR 240.15c2-12(a)).

Further, Zions's comments do not demonstrate – and the MSRB is not aware of any indication – that Congress intended the requirements of the CRA to take precedence over other statutory and regulatory requirements, including those designed to address a category of transactions that pose a high risk of self-dealing.

Exception if Represented by a Separate Registered Municipal Advisor

SIFMA commented that Proposed Rule G-42(e)(ii) should be revised to permit an otherwise prohibited principal transaction where the municipal entity is represented by a separate registered municipal advisor ("SRMA") with respect to the principal transaction. SIFMA noted that often a municipal entity hires several municipal advisors to advise on different matters relating to the same transaction, and suggests that although generally, each municipal advisor would be prohibited from engaging in principal transactions with the municipal entity, an exception should exist for a municipal advisor when a second municipal advisor that is already representing the municipal entity regarding "other subject matter" could act as the SRMA for any principal transaction that relates to the scope of that second municipal advisor's representation. SIFMA commented that the SRMA exception was analogous to SEC Rule 15Ba1-1(d)(3)(vi),[40] under which a person engaging in municipal advisory activities is exempt from the municipal advisor definition where the municipal entity client (or an obligated person client) is otherwise represented by an independent registered municipal advisor ("IRMA") with respect to the same aspects of a municipal financial product or an issuance of municipal securities, provided specific additional requirements are met.

Although SIFMA stated that the SRMA exception should be permitted because it is analogous to the exemption based on the use of an IRMA (the "IRMA exemption"), the MSRB does not believe that permitting a municipal advisor to engage in a principal transaction with its municipal entity client when a second municipal advisor, referred to as a SRMA, is present to advise the municipal entity is sufficiently analogous to the IRMA exemption. When a person or an entity acts in reliance upon the IRMA exemption, the person or entity so acting is not considered to be giving advice to the municipal entity and is not in a fiduciary relationship with the municipal entity. SIFMA's proposal would provide an exception to a firm that is giving advice and has a fiduciary duty to the municipal entity. In addition, the MSRB believes that incorporation of an exception like that suggested would, at this stage, be premature. The prohibition on principal transactions, if implemented, will be a new restriction applicable to activities that previously were not specifically federally regulated, and such an exception likely would be complex and potentially burdensome to administer. In order to provide the appropriate protection to municipal entities, a number of conditions would likely be imposed, such as substantial additional relationship documentation, including, for example, documentation of the SRMA's agreement to serve as such, executed by the SRMA, the municipal entity client and the non-SRMA municipal advisor, documentation that the principal transaction to be executed, in fact, is within the scope of the SRMA's representation to the municipal entity client, and documentation of the non-SRMA's conflicts of interest, both generally and specific to the non-

[40] 17 CFR 240.15Ba1-1(d)(3)(vi).

SRMA's role as counter-party in the particular principal transaction, among others. In light of these considerations, the MSRB may consider incorporating this or a similar exception to the prohibition on principal transactions at a future date after obtaining experience with the new requirement.

Relationship between MSRB Rule G-23 and the Prohibition on Principal Transactions

Two comments were received regarding proposed paragraph .07 of the Supplementary Material (proposed paragraph .07 is renumbered in Amendment No. 1, and hereinafter referred to, as proposed paragraph .08 of the Supplementary Material), referring to the relationship between MSRB Rule G-23 and Proposed Rule G-42, including the prohibition on principal transactions in proposed subsection (e)(ii). The final sentence of proposed paragraph .08 states that the prohibition in proposed subsection (e)(ii) would not apply to an acquisition as principal, either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from an issuer all or any portion of an issuance of municipal securities on the basis that the municipal advisor provided advice as to the issuance "because that is a type of transaction that is addressed and prohibited in certain circumstances by Rule G-23." BDA and NAMA commented that the sentence is unclear. BDA interpreted the prohibition in Rule G-23 as subsumed by the more stringent provisions of Proposed Rule G-42. In NAMA's view, the additional activities or principal transactions to be prohibited under Proposed Rule G-42 don't conflict with Rule G-23, but merely supplement the prohibitions in Rule G-23.

The MSRB previously indicated that the effect of the sentence in proposed paragraph .08 is intentionally quite limited, and, as to Rule G-23, the sentence provides an exception only to the specific prohibition on principal transactions in Proposed Rule G-42(e)(ii). The MSRB further explained that the specific ban on principal transactions in proposed subsection (e)(ii) does not prohibit a type of principal transaction that is already addressed and prohibited to a certain extent by Rule G-23. To further clarify the meaning and intent, the MSRB included, in Proposed Rule G-42(e)(ii), language from Rule G-23. Thus, where certain conduct is permitted under Rule G-23 (as an exception to the general prohibition therein), Proposed Rule G-42(e)(ii) (the principal transaction provision) alone does not prohibit such conduct. Notwithstanding, other parts of Proposed Rule G-42 and statutory provisions must be considered to determine whether the conduct, although permitted under Rule G-23 and not specifically prohibited under Proposed Rule G-42(e)(ii), would violate another provision of Proposed Rule G-42 or other MSRB rules or other laws or regulations.[41]

Other Comments Received

Sophisticated Municipal Issuer Exemption

First Southwest, as in a comment that it made in response to a previous request for comment, stated that "certain issuers are capable of independently evaluating risks in issuing

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41 See 80 FR 26752, at 26782-26783.

municipal securities, and exercising independent judgment in evaluating recommendations of a municipal advisor" and it would be appropriate to provide an exemption to the suitability standard (in proposed section (d) and proposed paragraph .08 of the Supplementary Material (renumbered in Amendment No. 1, and hereinafter referred to, as proposed paragraph .09 of the Supplementary Material)) in connection with such "sophisticated municipal issuers."[42]

The MSRB continues to believe the requirements of proposed section (d), and the related proposed paragraphs of the supplementary material, should be applicable regardless of the sophistication of the municipal entity or obligated person client. When adopting the SEC Final Rule, the SEC did not include an exemption from registration as a municipal advisor for persons providing advice to clients of a certain sophistication.[43] Given that municipal advisors have become subject only recently to the SEC's regulatory framework governing their registration, and the MSRB is developing its regulatory framework for municipal advisors, the MSRB believes that it would be premature to categorically exclude certain clients from the protections of the proposed rule.[44] Proposed Rule G-42 is aimed at protecting municipal entities, obligated persons, investors and the public interest and, as a result, the MSRB believes that, at this time, the suggested exemption from the suitability obligation is not appropriate.

Request for Prospective Application of Proposed Rule G-42 Requirements

ICI and SIFMA commented that the MSRB should clarify that, if approved, Proposed Rule G-42 would only apply prospectively to municipal advisory relationships entered into, or recommendations of municipal securities transactions or municipal financial products to an existing municipal entity or obligated person client made after the effective date of the proposed rule. Specifically, SIFMA stated that a municipal advisor should not be required to provide "new disclosures or additional relationship documentation to supplement or modify the terms of engagements that exist" prior to the rule proposal being in effect.

The MSRB believes that the requirements of the proposed rule change reasonably ensure that a municipal advisor client will receive the benefit of appropriate disclosure and clear communication, yet will not overly burden either the client or the municipal advisor.[45] To this end, Proposed Rule G-42 would not require the creation of new contractual relationships or the modification of existing contracts or agreements between municipal advisors and their clients

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42 See First Southwest comment letter in response to the First Request for Comment. See also 80 FR 26752, at 26776 (MSRB discussed, and responded to, the same or substantially similar comments).

43 See generally release adopting SEC Final Rule.

44 See 80 FR 26752, at 26776.

45 See 80 FR 26752, at 62769 (MSRB discussed, and responded to, the same or substantially similar comments).

when the rule takes effect. Indeed, although Proposed Rule G-42 would require documentation of the municipal advisory relationship, it, as stated previously, would not require a contract between the parties. Moreover, so long as the content of the documentation adheres to the requirements of Proposed Rule G-42, municipal advisors and their clients would have some latitude in deciding the exact form of the documentation and writing. If municipal advisors have already delivered documentation meeting some or all of the requirements of proposed section (c), then municipal advisors would be able to rely on such documents to satisfy some or all of their obligations under section (c). Documents in place prior to the effective date that are in some way deficient are not required to be withdrawn. Instead, they may be supplemented by the municipal advisor by the delivery of additional documentation that satisfies any remaining requirements of Proposed Rule G-42. With regard to recommendations or reviews of recommendations of others, the specific requirements of the proposed rule change would apply only to recommendations made or reviewed after the proposed rule change becomes effective. In addition, upon the proposed rule change taking effect, municipal advisors will become subject to the applicable standards of conduct (e.g., Proposed Rule G-42's specified duty of care and duty of loyalty) with regard to all of their municipal advisory activities, regardless of whether the relevant engagement began prior to the effective date of the rule.[46] Finally, under recently effective MSRB Rule G-44 (Supervisory and Compliance Obligations of Municipal Advisors), all municipal advisors will be required to have written supervisory procedures that are reasonably designed to ensure that they and their associated persons are in compliance with the proposed rule change, if approved, after it takes effect.

Use of Supplementary Material in Proposed Rule G-42

In its comment letter, PFM expressed its general support for the proposed rule change but stated that all supplementary material should be deleted. PFM stated that all the material contained in the supplementary material to Proposed Rule G-42 should "be [included] into the Rule itself" because otherwise there might be an "inconsistent application by registrants [of the proposed rule] and the potential for unintended consequences as a matter of the statute itself." PFM stated that it does not disagree with content contained in the proposed supplementary material, only that it is somehow less precise than it would be if it were integrated into the paragraphs of the proposed rule text.

The structure of Proposed Rule G-42 (with rule language followed by supplementary material) is intentionally consistent with the structure used by Financial Industry Regulatory Authority ("FINRA") and other self-regulatory organizations ("SROs"). The MSRB has been transitioning to this structure for all of its rules to streamline the rules, harmonize the format of its rules with that of other SROs, and make the rules easier for dealers and municipal advisors to

46 Although Proposed Rule G-42 would apply prospectively to a municipal advisory relationship, municipal advisors currently are required to deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice under MSRB Rule G-17, and have been subject to a statutory fiduciary duty with respect to their municipal entity clients under the Dodd-Frank Act since 2010 (see supra n. 5).

access, understand and follow, which, collectively, the MSRB believes will foster a number of efficiencies. Finally, the MSRB notes that since it began implementing this format in new MSRB rules and amendments to existing rules, the MSRB has not to date observed the types of issues or concerns raised by the commenter.

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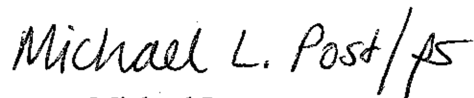
The MSRB believes that Proposed Rule G-42, which is designed to establish the core standards of conduct and duties of municipal advisors, represents a significant milestone in the development of a comprehensive regulatory framework for municipal advisors and is a substantial advancement in fulfilling the MSRB's mandate to protect municipal entities, obligated persons, investors and the public interest.

If you have any questions, please feel free to contact me, Sharon Zackula, Associate General Counsel, or Benjamin Tecmire, Counsel at (703) 797-6600.

Sincerely,



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