



# Municipal Advisors: Understanding Standards of Conduct

## APPLICABLE MSRB RULE

Effective June 23, 2016, Municipal Securities Rulemaking Board (MSRB) Rule G-42 establishes core standards of conduct for municipal advisors engaging in municipal advisory activities, other than municipal advisory solicitation activities. The rule also establishes requirements for many aspects of the relationship between a municipal advisor and its client by addressing the disclosure of conflicts of interest, documentation of the relationship, recommendations and conduct that is specifically prohibited. When a municipal advisor's client is a state or local government or another governmental entity to which the municipal advisor owes a duty of loyalty, Rule G-42 also prohibits the municipal advisor and its affiliates from engaging in certain principal transactions with the client.

## USE OF THIS DOCUMENT

This document is designed to provide a brief overview of the duties and obligations under Rule G-42 for municipal advisors. This overview is intended to assist municipal advisors in understanding and complying with Rule G-42 when they engage in municipal advisory activities, and in developing and implementing appropriate policies and procedures. Please note that this document does not address all of the requirements of Rule G-42 and other applicable MSRB or Securities and Exchange Commission (SEC) rules related to municipal advisors. In addition, this overview does not create a safe harbor with respect to potential violations of Rule G-42. Instead, this document is offered as a tool to assist municipal advisors in complying with Rule G-42.

## CONSIDERATIONS

**Standards, Duties and Obligations:** Rule G-42 establishes certain standards of conduct for municipal advisors.

- When performing municipal advisory activities for a municipal entity client or an obligated person client, a municipal advisor must act in accordance with a duty of care.

- ▶ Supplemental Material (SM) .01 of Rule G-42 provides additional guidance regarding what it means to act subject to a duty of care. Specific duties derived from the broader duty of care require a municipal advisor, for example, to: possess the degree of knowledge and expertise needed to provide a particular client informed advice; to 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 have a reasonable basis for any advice provided to the client.
- ▶ The more specific duties and obligations identified in SM .01 are only the starting point for a municipal advisor to consider in determining its obligations to its clients and compliance with the broad duty of care under Rule G-42.
- When performing municipal advisory activities for a municipal entity client, a municipal advisor must act in accordance with its fiduciary duty to the client, which includes a duty of care and a duty of loyalty. This standard is consistent with the statutory fiduciary duty owed by a municipal advisor to its municipal entity clients under Section 15(c)(1) of the Securities Exchange Act of 1934.
- ▶ SM .02 provides additional guidance regarding the duties and obligations of a fiduciary acting subject to a duty of loyalty. Under SM .02, the duty of loyalty requires a municipal advisor to deal honestly and with the utmost good faith with the municipal entity client; act in the best interests of the client without regard to the interests of the municipal advisor; and not engage in municipal advisory activities if the municipal advisor cannot manage or mitigate its conflicts of interest in a manner that will permit it to act in the municipal entity's best interest.

*This document provides only a brief overview of MSRB Rule G-42. Municipal advisors should refer to the text of Rule G-42, MSRB Notice 2016-03 (January 13, 2016) and related materials on the MSRB website to gain a complete understanding of Rule G-42.*

- ▶ Similar to the guidance in SM .01, the more specific duties and obligations of a fiduciary identified in SM .02 are only the starting point for a municipal advisor to consider in meeting its obligations to municipal entity clients under the broad duty of loyalty.
- Municipal advisors are also subject to other duties and obligations under other MSRB rules. Under Rule G-17, a municipal advisor is subject to a duty of fair dealing and is prohibited from engaging in any deceptive, dishonest or unfair practice.

### Disclosure of Conflicts of Interest and Other

**Information:** Rule G-42 requires a municipal advisor to make full and fair disclosure, in writing, of all material conflicts of interest and all legal and disciplinary events that are material to a client's evaluation of a municipal advisor. The disclosures must be provided prior to or upon engaging in municipal advisory activities for or on behalf of the client.

- Regarding conflicts of interest, a municipal advisor must disclose:
  - ▶ Information regarding any of the multiple scenarios identified in the rule, which are viewed as always giving rise to a material conflict of interest (e.g., certain fee-splitting arrangements and certain payments to third parties); and
  - ▶ Any other actual or potential conflicts of interest, which a municipal advisor is aware of after reasonable inquiry, that could reasonably be anticipated to impair the municipal advisor's ability to provide advice in accordance with the established standards of conduct.
  - ▶ Other scenarios also may give rise to a material conflict of interest and require a municipal advisor to make disclosure to the client.
  - ▶ If, after reasonable diligence, a municipal advisor determines that it has no known material conflicts of interest to disclose, it must notify the client of this determination in writing.
- A municipal advisor also must disclose 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. Provisions in Rule G-42 facilitate the use of existing public records to make the disclosures regarding legal and disciplinary events in a cost-effective manner.

### Documentation of the Municipal Advisory Relationship:

Rule G-42 requires documentation of the municipal advisory relationship.

- A municipal advisory relationship must be evidenced in writing, and the documentation must be dated and delivered to the client prior to, upon or promptly after the municipal advisory relationship is established.
- The documentation must include certain information and aspects of the relationship:
  - ▶ The scope of municipal advisory activities to be performed;
  - ▶ Disclosures of conflicts of interest and legal and disciplinary events of the same scope as described above in "Disclosure of Conflicts of Interest and Other Information;"
  - ▶ A description of specific types of information regarding legal and disciplinary events requested by SEC Form MA and MA-I, detailed information specifying where the client may electronically access the most recent SEC forms, the date of the last material change or addition to the legal and disciplinary events disclosures on the SEC forms, and a brief explanation of the materiality of the amended portion of the form;
  - ▶ Limitations, if any, on the scope of the engagement; and
  - ▶ The date or triggering event, or other means providing for the termination of the municipal advisory relationship.
- To provide additional flexibility and avoid duplicative disclosures, under SM .06, a municipal advisor is not required to include in the relationship documentation the disclosures of conflicts of interest and legal and disciplinary events if the municipal advisor previously fully complied with the rule's disclosure requirements and there have been no material changes in the information since it was provided to the client.

**Inadvertent Advice:** If a municipal advisor inadvertently engages in municipal advisory activities for a municipal entity or an obligated person but does not intend to continue or enter into a municipal advisory relationship with the municipal entity or the obligated person, SM .07 sets forth alternatives to providing the disclosures of conflicts of interest and information regarding legal and disciplinary events, and complying with the documentation requirements.

- To take advantage of this provision, a municipal advisor who has inadvertently engaged in such municipal advisory activities (even if a municipal advisor solely based on the inadvertent activities) must comply with several requirements, including acting as promptly as possible to notify the recipient of various matters in writing after the municipal advisor discovers that it has inadvertently provided advice to the municipal entity or the obligated person. For example, the dated document provided to the recipient of the advice must include a disclaimer that the municipal advisor did not intend to provide the advice, that, effective immediately, the municipal advisor has ceased doing so, and an identification of all the advice that was inadvertently provided.
- A municipal advisor that satisfies the requirements of SM .07 is not required to provide disclosures of conflicts of interest and other information under Rule G-42(b) and relationship documentation under Rule G-42(c) to the recipient of the advice, but remains subject to all other provisions of Rule G-42.

**Recommendations:** If making a recommendation to a client, a municipal advisor must have a reasonable basis to believe that the recommendation is suitable, based on information obtained through the reasonable diligence of the municipal advisor. If requested by the client to review the recommendation of another person and within the scope of the engagement, a municipal advisor must determine, based on the information obtained through the reasonable diligence of the advisor, whether the municipal securities transaction or municipal financial product is or is not suitable for the client.

- For both types of review, a municipal advisor must inform the client of:
  - ▶ The municipal advisor's evaluation of the material risks, potential benefits, structure and other characteristics of the recommended municipal securities transaction or municipal financial product;
  - ▶ The basis upon which the advisor reasonably believes the recommended transaction or product, is suitable for the client;
  - ▶ If reviewing the recommendation made by another to the client, the basis upon which the municipal advisor reasonably believes the recommended transaction or product is or is not suitable for the client; and
- ▶ Whether the municipal advisor has investigated or considered other reasonably feasible alternatives that might also or alternatively serve the client's objectives.
- In making a suitability determination, a municipal advisor must consider numerous factors, as applicable to the particular type of client, and any other material information known by the municipal advisor about the client and the municipal securities transaction or municipal financial product, after reasonable inquiry. SM .09 sets forth a non-exclusive list of factors regarding the client that may be relevant in making a suitability determination:
  - ▶ The client's financial situation, objectives, tax status, risk tolerance and liquidity needs;
  - ▶ The client's experience with municipal securities transactions or municipal financial products generally or of the type and complexity being recommended; and
  - ▶ The client's financial capacity to withstand changes in market conditions during the period the instrument is reasonably expected to be outstanding.
- A municipal advisor is required to "know your client," which means it must use reasonable diligence to know and retain the essential facts concerning a client, including persons having authority to act on behalf of the client. Under SM .10, the facts "essential" to knowing a client include those required to:
  - ▶ Effectively service the municipal advisory relationship with the client;
  - ▶ Act in accordance with any special directions from the client;
  - ▶ Understand the authority of each person acting on behalf of the client; and
  - ▶ Comply with applicable laws, regulations and rules.

**Specifically Prohibited Activity:** Rule G-42 specifically prohibits a municipal advisor from engaging in certain activities, including:

- Receiving excessive compensation (refer to SM .11 for additional guidance regarding this topic, including factors to consider);
- Delivering inaccurate invoices for fees or expenses;

- Making false or misleading representations about the municipal advisor's resources, capacity or knowledge;
- Participating in fee-splitting arrangements with an underwriter of the same transaction for which the municipal advisor is providing advice, and participating in any undisclosed fee-splitting arrangements with providers of investments or services to a municipal entity or obligated person client of the municipal advisor; and
- Making payments for the purpose of obtaining or retaining an engagement to perform municipal advisory activities, with certain identified exceptions.

**Prohibited Principal Transactions:** Rule G-42 specifically prohibits a municipal advisor, and any affiliate of the municipal advisor, from engaging in certain principal transactions with a municipal entity client. The prohibition applies if the principal transaction is the same or directly related to the issue of municipal securities or municipal financial product for which the municipal advisor is providing or has provided advice to the client. An exception exists for certain fixed income securities transactions.

- The specified ban on principal transactions applies only to principal transactions between a municipal advisor (or its affiliate) and a municipal entity client. The ban does not apply to principal transactions between a municipal advisor (or its affiliate) and an obligated person client, although in a transaction with an obligated person client, a municipal advisor must remain cognizant of, and comply with, for example, the broad duties of care and fair dealing that apply to all of its conduct with an obligated person client.
  - "Principal transaction" includes sales or purchases of any security or entrance into any derivative, guaranteed investment contract or other similar financial product. Under SM .13, certain bank loans of \$1 million or more may be an "other similar financial product."
  - An exception exists for certain fixed income securities transactions executed in a principal capacity by a municipal advisor with its municipal entity client.
  - The exception is subject to several conditions and limitations set forth in SM .14, which should be carefully reviewed (e.g., the exception does not apply to the affiliates of a municipal advisor and does not apply to transactions involving municipal escrow investments).
- Key terms, including the fixed income securities that may be purchased or sold using the exception, are defined in SM .15.
- The exception provides a municipal advisor with two options under which the municipal advisor is not specifically prohibited from engaging in fixed income securities principal transactions with a municipal entity client.
    - ▶ The first option permits a municipal advisor to make the requisite disclosures on a transaction-by-transaction basis, while following a short set of procedural requirements.
    - ▶ The second option allows the municipal advisor to make the requisite disclosures on an other than transaction-by-transaction basis, but the municipal advisor is subject to more procedural requirements, including a requirement to obtain prospective blanket written consent from the municipal entity client to execute such fixed income securities transactions as principal.
  - Although the exception removes certain principal transactions in fixed income securities from the specified prohibition in Rule G-42, the municipal advisor must remain cognizant of, and comply with, its broad fiduciary duty that applies to all of its conduct with a municipal entity client.

## OTHER MATTERS

- Municipal advisors may be subject to fiduciary or other duties under state or other laws. Rule G-42 does not supersede, for example, any more restrictive state or other federal law regarding fiduciaries.
- Rule G-42 applies to municipal advisors that advise sponsors or trustees of 529 college savings plans or similar plans or funds involving municipal fund securities.

**Related Provisions of MSRB Rule G-8:** Each municipal advisor is required to make and keep a copy of any document that the municipal advisor created that was material to its review of a recommendation by another person or memorializes the municipal advisor's basis for a determination regarding suitability. In addition, note that municipal advisors must follow the broad recordkeeping requirements that have been adopted by the SEC.