MSRB
Municipal Securities Rulemaking Board

Underwriters: Understanding Duties of Municipal Advisors

OVERVIEW

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. Implementation of Rule G-42 and earlier changes to the Securities Exchange Act of 1934 have implications for underwriters and the activities that fall within the scope of an underwriting. This document reviews the respective roles and responsibilities of underwriters and municipal advisors, discusses the provision of "inadvertent advice" under Rule G-42 and provides an overview of the rule itself to assist brokers, dealers and municipal securities dealers (collectively, "dealers") acting as underwriters in understanding the regulatory framework that applies to municipal advisors. The MSRB is committed to providing resources and conducting outreach to financial professionals who, while experienced in their field, may be unfamiliar with Rule G-42 and other aspects of the developing federal regulatory framework for municipal advisors.

ESTABLISHING THE RESPECTIVE DUTIES AND OBLIGATIONS OF THE UNDERWRITER AND THE MUNICIPAL ADVISOR

As a result of amendments to the Securities Exchange Act of 1934 that became effective October 1, 2010, municipal advisors, as defined in the Exchange Act, are required to register with the Securities and Exchange Commission (SEC), unless subject to a statutory exclusion or exempted by the SEC. Dealers serving as underwriters are statutorily excluded. Subsequently, in SEC rules interpreting the statutory requirements for municipal advisors, a broad range of activities were identified that, if engaged in, would trigger the requirement to register as a municipal advisor, absent an exclusion or SEC exemption. The SEC also interpreted the breadth of the underwriter exclusion to cover a dealer serving as an underwriter of a particular issuance of municipal securities that engages in activities that are within the scope of the underwriting of such issuance of municipal securities.[1] Some of the activities triggering registration as a municipal advisor overlap with those that a dealer acting as an underwriter may perform or provide in connection with an issuance of municipal securities.[2]

To provide effective representation to a client that has engaged both a municipal advisor and an underwriter, the client and the client's underwriter and municipal advisor should have a complete understanding of the duties and obligations — and the scope of the respective roles — of the underwriter and the municipal advisor. In particular, the underwriter and municipal advisor should be aware and discuss with their client the duties and obligations of the underwriter and the municipal advisor regarding advice or services to be provided to the client — particularly advice or services that would require registration as a municipal advisor, in the absence of the underwriter exclusion (or another exclusion or an SEC exemption), and may be provided to the client, at the discretion of the client and under the terms of the relationships, by either the municipal advisor or the underwriter in compliance with the current regulatory framework. All parties should consider the benefits of having the scope of each professional's duties and obligations to the client discussed in advance and set forth in writing.

CORE STANDARDS OF CONDUCT UNDER MSRB RULE G-42

Rule G-42 establishes certain core standards of conduct and duties and obligations for municipal advisors that engage in municipal advisory activities. The term "municipal advisory activities" as used in Rule G-42 has the same meaning as adopted by the SEC, except obligations and duties regarding municipal advisory solicitation activities are not addressed. The standards of conduct, duties and obligations apply when a municipal advisor is providing, or has provided, advice to a state or local government, another type of "municipal entity" or a conduit borrower (obligated person) regarding an issue of municipal securities or a municipal financial product.

This document provides only a brief overview of MSRB Rule G-42. Underwriters should refer to the text of Rule G-42, MSRB Notice 2016-03 (January 13, 2016) and related materials on the MSRB's website for more information on the rule, other MSRB rules and rulemaking initiatives, and additional educational material.

Duty of Care

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:
  - 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;
  - Have a reasonable basis for any advice provided to the client;
  - Undertake a reasonable investigation to determine that the municipal advisor is not basing any recommendation on materially inaccurate or incomplete information;
  - Have a reasonable basis for any representations made in a certificate that it signs that will be reasonably foreseeably relied upon by the client, any other party involved in a municipal securities transaction or municipal financial product, or investors; and
  - Have a reasonable basis for any information provided to the client or other parties involved in a municipal securities transaction in connection with the preparation of an official statement for any issue of municipal securities as to which the advisor is advising.
- All of 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.

Fiduciary Duty

In contrast to an underwriter, 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 fiduciary duty owed by a municipal advisor to its municipal entity clients under Section 15(c)(1) of the Exchange Act. SM .02 provides additional guidance regarding certain duties and obligations of a fiduciary 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 and act in its best interests without regard to the interests of the municipal advisor; and
  - Precludes a municipal advisor from engaging in municipal advisory activities with a municipal entity client if it cannot manage or mitigate its conflicts of interest in a manner that will permit it to act in the client's best interests.
- 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 duty of loyalty.
- Municipal advisors are also subject to duties and obligations under other MSRB rules. Under Rule G-17, for example, a municipal advisor, like an underwriter, 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. The disclosures of certain conflicts of interest is similarly required of underwriters under Rule G-17.[3]

- 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 (certain fee-splitting arrangements and certain payments to third parties);
  - 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; and

- Other scenarios that may give rise to a material conflict of interest.
- 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.

DOCUMENTATION OF THE MUNICIPAL ADVISORY RELATIONSHIP

Rule G-42 requires documentation of the municipal advisory relationship. Under Rule G-17, documentation of several similar aspects of the underwriter-issuer relationship is also required.

- 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, and related information, including material changes or additions to the legal and disciplinary events disclosures;
  - 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.
- Rule G-42 does not require that the writing(s) evidencing the municipal advisory relationship with the issuer be a bilateral agreement or contract. A similar approach is taken regarding the documentation of the underwriter-issuer relationship under Rule G-17.

INADVERTENT ADVICE

If a person inadvertently engages in municipal advisory activities for a municipal entity or an obligated person but does not intend to continue or to enter into a municipal advisory relationship with the municipal entity or the obligated person, SM .07 of Rule G-42 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 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. A municipal advisor that satisfies the requirements of SM .07 is not required to provide disclosures and other information under Rule G-42(b) and relationship documentation under Rule G-42(c) to the municipal entity or obligated person, but remains subject to all other provisions of Rule G-42.[4]

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 reasonable diligence, 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 municipal 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 provides 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 use reasonable diligence to know and retain the essential facts concerning a client and each person acting 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

Similar to the interpretive guidance applicable to underwriters under Rule G-17, Rule G-42 includes specific prohibitions for municipal advisors, 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 a 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.[5]

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 a 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 transactions include 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 are 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 narrow 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.[6]
  - 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.[7]
- Although the exception to the ban on principal transactions removes certain 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 also 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.

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1 SEC Order Adopting Final Rules regarding the Registration of Municipal Advisors, Securities Exchange Act Release No. 70462 (September 20, 2013), 78 FR 67468, at 67511-16 (November 12, 2013) (SEC Final Rule).

2 In the SEC Final Rule, the SEC identifies certain activities as within the scope of an underwriting of a particular issuance of municipal securities, and permissible for the underwriter, pursuant to the underwriter exclusion, to engage in on behalf of the client without being required to register as a municipal advisor. In summary, activities that the SEC identifies as within the scope of an underwriting include, but are not limited to: (1) advice regarding the structure, timing, terms, and other similar matters concerning a particular issuance of municipal securities; and (2) assistance with the following activities (if provided in connection with the particular issuance of municipal securities for which the dealer is retained as underwriter) — the preparation of and presentation of ratings information; the development of rating strategies and presentations; investor road shows; the preparation of the preliminary and final official statements; and assisting in aspects of the closing.

The SEC also indicated that advice on investment strategies (*i.e.*, plans or programs for the investment of proceeds of municipal securities that are not municipal derivatives or guaranteed investment contracts, and the recommendation of and brokerage of municipal escrow investments) and advice on municipal derivatives would be outside the scope of the underwriting exclusion.

3 See MSRB Notice 2012-25, Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities (published May 7, 2012) (2012 Notice). For example, the 2012 Notice requires an underwriter to disclose that it is not a fiduciary to the issuer, information regarding its compensation, certain payments to or from third parties, arrangements regarding profit sharing with investors, and other issues.

4 If a municipal advisor inadvertently engages in municipal advisory activities with an issuer, the municipal advisor must also consider whether it has rendered financial advisory or consultant services under MSRB Rule G-23.

5 See 2012 Notice. Some of the same conduct specifically prohibited in new Rule G-42 is described in the 2012 Notice as conduct constituting an unfair practice by underwriters with regard to issuers under Rule G-17 (*e.g.*, charging excessive compensation, making payments to or receiving payments from undisclosed third parties).

6 Some of the procedural requirements are similar to those in Section 206(3) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6(3).

7 Some of the procedural requirements are similar to those in Investment Advisers Act Rule 206(3)-3T, 17 CFR 275.206(3)-3T.