Leslie Carey

From: Robert Doty
Sent: Thursday, September 30, 2010 2:25 PM
To: Leslie Carey
Subject: Comment of Rule G-23
Attachments: Recognize Advisors Duty, Don't Destroy IT.pdf

Ms. Carey,

As my comment on the proposed changes to Rule G-23, I am attaching my commentary published earlier this year in The Bond Buyer.

Robert Doty

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COMMENTARY

Recognize Financial Advisers' Duty, Don't Destroy It

Monday, April 5, 2010

By Robert Doty

Things get stranger and stranger. Consequences are serious. Two key areas are MSRB Rule G-23 and the legislation approved by the Senate Banking Committee that includes plans for regulating financial advisers. Make no mistake – issuer protections are at stake.

First, fiduciary duty and the Municipal Securities Rulemaking Board's Rule G-23, allowing advisers to resign to underwrite issuers' securities by informing the issuers merely that a conflict of interest "may" exist.

I have substantial respect for Lynnette Hotchkiss, the MSRB's executive director, and other board staff members. The board has made significant contributions, especially its Electronic Municipal Market Access, or EMMA, Web site, but that does not excuse the board's blindness regarding financial advisers' fiduciary duty to issuers.

The Government Finance Officers Association urges issuers to employ financial advisers in both competitive and negotiated offerings and that compensation be noncontingent. Advisers are essential to tens of thousands of unsophisticated issuers, as well as and other issuers. GFOA opposes Rule G-23 "because disclosure and consent are not sufficient to cure the inherent conflict of interest."

Unless Congress, the Securities and Exchange Commission and the market find ways for the extensive and diverse issuer universe to benefit from competent unconflicted financial advice, many financial tragedies for issuers will be repeated in Tennessee, Wisconsin, Pennsylvania and elsewhere. As the complexity of financial products and regulation grows, issuers increasingly require sound advice. Investors benefit by avoidance of unsound transactions.

Many advisers are able to provide quality unconflicted services to issuers. Independence does not turn on whether an adviser is or isn't a dealer, but rather upon whether advisers have conflicts of interest with their issuer clients.

In contrast to technical MSRB actions, the board's approach to fiduciary duty demonstrates that dealer self-regulation is not viable in this area. The MSRB failed to utilize regulatory due diligence, ask obvious questions, and formulate sound policy.

The current board charged Hotchkiss with defending the indefensible. As reported, she recently acknowledged that Rule G-23 "is clearly one of the most contentious issues at the board." Yet, she has asserted: "Studies of trade data are inconclusive that there are any unusual pricing spreads that issuers receive on negotiated transactions in which the dealer-adviser has resigned as adviser to underwrite the deal."

This suggests breaching advisers' duty to act solely in issuers' best interests is justified unless prices are proved to have been affected.

It does not acknowledge numerous issuers and their taxpayers in Tennessee, Wisconsin, Pennsylvania – 107 school districts, according to the Wall Street Journal – and elsewhere, small and unsophisticated, that lost enormous amounts after inducement to issue variable-rate demand obligation securities joined at the hip with interest rate swaps, or into borrowing to purchase credit default swaps.

Some issuers had advisers — sometimes recommended by dealers marketing financial products — who had relationships with dealers and contingent fees payable upon transactional completion. Many issuers dealt with firms represented on the board.

Price is only one issue. The first issue competent advisers confront is whether issuers even should enter into transactions. A second is risks issuers face and how to mitigate or avoid them.

Hotchkiss also indicated the MSRB had received from "many, many issuers" letters purportedly in favor of issuer choice asking that the rule not be changed.

Indeed, the board received a large number of issuer form letters. An overwhelming majority of those — 51 out of 66 — came from Texas, where dual advisory and underwriting roles have prevailed. One-third of the Texas letters came from municipal utility districts formed for private developments and often governed by developers.

That the MSRB would consider such letters to contain even a shred of realism brings into question the motivations and diligence of board members opposing disclosure to issuers.

The principal proposal would have done nothing to alter issuer choice, but rather emphasized disclosure that there "will" (not "may") be conflicts of interest in changing roles; what the conflicts are; that generally a dealer no longer would be in a fiduciary relationship with the issuer and no longer providing advice in the issuer's best interests; and identifying significant issuer consequences. The proposal emphasized the importance of making disclosures to issuers' policy-makers, not only to finance officials.

Clearly, the issuers did not understand the topic because the letters reflect a pervasive concern that the proposal would limit their choice of underwriters.

For example, an often repeated verbatim sentence states "any limiting of the ability of financial advisers to serve as underwriter ... could harm the [issuer] without providing ... protection." Yet board members opposing disclosure to issuers failed to acknowledge that obvious discrepancy.

Another interesting element in the board's new G-23 defense, as stated by Hotchkiss, is issuers' concern "because in our locality we don't have 50 investment bankers looking for our business."

Those issuers' financial advisers are misleading them again — this time in conducting actual transactions — about the advisers' roles and the market for the issuers' securities. If the advisers were performing their jobs properly, and not violating their fiduciary duty so severely, they would be actively contacting potential underwriters, not attempting to grab for themselves the underwriting positions in which the advisers become issuers' adversaries.

I have met remote Wyoming issuers that received visits from multiple bankers. I have worked with tiny California issuers who have no difficulty attracting bankers. Yet, there might be interference with competition in certain states. A personal note — when I was a banker in Texas and Colorado, bankers allocated clients. They avoided soliciting business from issuers having continuing advisory contracts with other bankers. Gaining employment as an adviser was considered an excellent path to underwriting. Resignations to underwrite were routine.

Given recent guilty pleas, allocations of business by supposedly competing bankers is not unrealistic. In the national price-fixing/bid-rigging investigations, reportedly 66 parties received target letters. Three firms represented on the MSRB are among 47 defendants in an action brought by the Sacramento Municipal Utilities District, based upon Bank of America information provided after the bank pled guilty. SMUD alleges a conspiracy among bankers and advisory firms, although allegations must be proved. One firm consented to an SEC enforcement release charging it with bribing officials in Jefferson County, Ala.

At the very moment firms seek to resign as advisers, they remain issuers' fiduciaries until finalization of resignations. The issuers' interests call for the highest price possible, while underwriters' interests, and the interests of the investors to whom the underwriters owe other duties, call for the lowest price.

The conflict is impossible to resolve. There are many other conflicts, especially in complex and riskier transactions, but that one illustrates the point. Tamar Frankel, a noted fiduciary duty expert, identified others in her paper (ignored by the MSRB) entitled "Let Me Advise You on How Much To Pay Me."

That the current board — containing representatives of several firms selling complex products to now badly damaged unsophisticated issuers — is attempting to mount a defense of the indefensible should be taken into account by Congress in structuring legislation to regulate advisers. All advisers should be regulated — dealers and nondealers. While some dealers may be conflicted, some nondealers are less than competent; others are fixated on contingent fees as opposed to providing sound advice, while others are hardly angels.

Clearly, the MSRB would fall short as currently structured or structured as proposed in the legislation drafted by Sen. Chris Dodd and approved by the Banking Committee to have purportedly "public" members that could remain under dealers' common control. There would not be a "level playing field" because there would not be parity between dealers and nondealers. Dealers would not fall within the definition of advisers. Enforcement of advisers' fiduciary duty — the heart of advisers' duties to issuers — would not be mandated.

The Dodd bill, ignoring Rule G-23's horrors and the abuses many issuers suffered, would place advisers — the issuers' guardians — at the mercy of adverse underwriters across the negotiating table. It would be like placing school lunchroom nutritionists under regulation by purveyors of colas, candy bars, cookies and worse — toxic products.

As my clients' nutritionist, my firm could not operate in that environment.

The House bill — providing for SEC regulation of all advisers — is what the market, issuers, and investors need.

Robert Doty is president of American Governmental Financial Services of Sacramento.