MSRB
Municipal Securities Rulemaking Board

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Market Advisory

Market Advisory on Issuer's Designation of Underwriter's Counsel

Introduction

The Municipal Securities Rulemaking Board (MSRB) is aware of the practice of certain municipal securities issuers designating the counsel of their underwriters, or influencing the underwriter's selection of counsel (both "issuer designation of counsel") in the offering of the issuer's bonds. This practice gives rise to actual or potential conflicts of interest in the counsel's representation of the underwriter, and calls into question counsel's ability to carry out its responsibilities with the necessary degree of independence from the issuer, to act with undivided loyalty and to be free from conflicting allegiances in providing legal counsel to the underwriter. Issuer designation of counsel also may compromise an underwriter's ability to retain counsel that has the requisite expertise and experience with the federal securities laws, and the resources needed to assist the underwriter in fulfilling its due diligence responsibilities.

The MSRB is publishing this market advisory to remind municipal market participants of the important role that underwriters play in bringing municipal securities to the market and counsel's role in assisting the underwriter; to note the increasing due diligence responsibilities of underwriters and their counsel; and to restate the importance of underwriter's counsel possessing the independence, expertise, experience and capacity necessary to perform the critical role of legal counsel to an underwriter during an underwriting of municipal securities.

Background

The MSRB first raised concerns regarding issuer designation of counsel in 1997 as part of a broader review of municipal securities underwritings,[1] and

[1] MSRB Reports Vol. 17 No. 2, *Board Review of Underwriting Process* (June 1997), *available at* http://www.msrb.org/msrb1/reports/0697v172/underjun.html

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in 1998, issued a Notice[2] stating that based on comments and information received, there were demonstrated problems regarding the practice. At that time, the MSRB urged both issuers and underwriters to ensure that underwriters select and utilize counsel in a manner that promotes investor protection.

The MSRB recognized that although issuers often have legitimate concerns regarding the selection of underwriter's counsel,[3] ultimately underwriters must be free to select their own counsel. The MSRB discussed the roles played by underwriter's counsel, and in connection with due diligence, stressed that an underwriter should have a basis for concluding that its counsel has the requisite experience and expertise in securities law matters, and the resources needed to assist the underwriter in due diligence.[4] The MSRB also noted the importance of the "counseling" role to be played by underwriter's counsel.

> the Board is concerned with the practice of certain issuers selecting underwriters' counsel on an issue. The underwriters' counsel customarily plays an important role in assisting underwriters in complying with the federal securities laws and, in particular, in providing an independent review of the issuer's disclosure. [*citation omitted*] The Board believes that, because underwriters ultimately are responsible for such review, they must be free to select counsel in whom they have confidence and who are free of the possibility of any conflicting allegiances to other parties involved in the underwriting process. When an issuer or its agent selects or influences the selection of a particular firm or individual to serve as underwriters' counsel, this may call into question the ability of such counsel to carry out its responsibilities with the necessary degree of independence. The Board believes that issuer involvement in the selection of underwriters' counsel could be a matter requiring disclosure to investors.

[2] MSRB, *Notice regarding issuer selection of underwriters' counsel* (September 3, 1998), *available at* http://msrb.org/msrb1/archive/1234.htm ("1998 Notice").

[3] 1998 Notice. The MSRB recognized that an issuer has a legitimate interest in the selection of any professional participating in the offering process, including underwriter's counsel, and the underwriter may fairly object to the selection of particular counsel in certain circumstances. The underwriter may fairly object to underwriter's counsel where the issuer's past experience with the counsel raises questions regarding counsel's competence or conduct. In addition, the issuer may wish to promote perceived efficiencies by desiring that underwriter's counsel be counsel whose knowledge, location or prior experience may facilitate prompt and proper completion of the financing. Further, the issuer may take an interest in encouraging underwriters to consider the use of local firms or firms in which minorities or women have significant responsibilities. Finally, the fees of counsel also are important to an issuer, since such fees are paid, directly or indirectly, by the issuer as an expense of the offering.

[4] 1998 Notice.

> Underwriters often need to take their counsel into their confidence on difficult and sensitive questions. Underwriters and therefore their counsel are "adverse" to issuers on a variety of matters, including many related to investor protection. ... [and] include decisions regarding bond structure, security provisions, operating and reporting covenants, and, above all, disclosure, especially in matters involving negative facts and circumstances. The potential for conflict of interest is inherent in the issuer's selection of the counsel whose particular responsibilities may include advocating decisions that the issuer may oppose or may perceive as not in its best interest.[5]

In performing both roles, the MSRB concluded that an underwriter should have a basis for determining that counsel has the requisite experience and expertise in securities law, as well as adequate resources and independence to perform the critical role of underwriter's counsel in the due diligence process. The MSRB also concluded that an underwriter must be free to reject the imposition of counsel in circumstances where the underwriter lacks the basis for placing their complete confidence in such counsel.

Current Practices in the Municipal Securities Market

Issuers today that designate underwriter's counsel cite their need to ensure that underwriter's counsel has the necessary qualifications, experience and familiarity with the issuer's finances, operations and practices; their interest in managing offering costs, which will include, directly or indirectly, the cost of underwriter's counsel; and in some cases, applicable policy or legal mandates, such as a mandate to include, or a preference for, local counsel or women- or minority-owned firms as part of the underwriting process.[6]

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[5] *Id.*

[6] *See* Government Finance Officers Association ("GFOA"), *GFOA Best Practice on Issuer's Role in Selection of Underwriter's Counsel* ("*2009 GFOA Statement*") (adopted October 2009), *available at* http://www.gfoa.org/issuer-s-role-selection-underwriter-s-counsel.

Although issuers identify the possible benefits of designating or influencing the selection of underwriter's counsel, in 2009, GFOA cautioned issuers to be aware that any undue influence by an issuer that calls into question the qualifications or independence of underwriter's counsel also may create risks to the issuer. In addition to the risk of the increased potential of inadequate disclosures regarding the issuer's bonds, discussed below, GFOA noted that an issuer incurs the risk that it may have "a reduced ability … to claim reliance on the expertise of its financing team."

The MSRB acknowledges such views and policies, but continues to believe that it is essential and fundamental to market integrity that the underwriter's counsel represent the underwriter during the underwriting process without regard to the interests of the issuer. Counsel must be prepared to assist the underwriter in fulfilling its many obligations during this period. Broadly, an underwriter is required to have a reasonable basis for recommending any municipal securities. An underwriter may establish this basis by engaging in a reasonable investigation of the disclosures in the offering statements, and, in particular, the key representations in such documents, to determine their truthfulness and completeness, and other information regarding the issuer, including, but not limited to, the issuer's continuing disclosures made pursuant to Exchange Act Rule 15c2-12,[7] the issuer's prior financings and media reports. If conflicted loyalties or lack of the necessary expertise or resources impedes the ability of the underwriter's counsel to perform its duties fully on behalf of the underwriter, there can be damaging consequences for investors, the underwriter, the issuer and a loss of investor confidence in the integrity of the municipal securities market.

The MSRB reiterates its concerns raised in the 1998 Notice that any offering practice that does not properly utilize independent, competent and appropriately critical underwriter's counsel may be harmful to investors. If underwriter's counsel fails to perform its duties with the rigor, independence and expertise required prior to marketing the securities, important and material information may be purposefully or unintentionally misrepresented or omitted. The MSRB is not aware of any recent evidence indicating that issuer-designated counsel willfully or negligently failed to engage in a reasonable investigation of issues assigned to it.[8] However, the conflicting loyalties of issuer-designated counsel and the influential role of such counsel during a key phase of the offering raise questions regarding the integrity and thoroughness of the due diligence process as well as the quality of representation provided by such counsel.

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[7] Under Exchange Act Rule 15c2-12, an underwriter is prohibited from purchasing or selling municipal securities in connection with an offering unless the underwriter has "reasonably determined" that an issuer or an obligated person has undertaken in a writing to provide continuing disclosure information regarding the security and the issuer or obligated person, which includes notices of the occurrence of certain events. Such notices must be provided within 10 business days of the occurrence of the event.

[8] When the MSRB first addressed this issue, the MSRB was aware of situations in which underwriters that used issuer-designated counsel had so little confidence in their counsel that they privately consulted other lawyers regarding disclosure and other matters. *See* 1998 Notice.

An underwriter also may suffer financial loss, reputational harm or both if it relies upon counsel either not sufficiently qualified or independent to properly engage in the reviews and otherwise perform the duties assigned to it by the underwriter. In such circumstances, an underwriter may, unknowingly, not have a reasonable basis for recommending the underwritten municipal security. If a municipal issuer engages in fraud without an underwriter's knowledge, both the issuer and the underwriter may be charged with violations of the anti-fraud provisions of the federal securities laws and MSRB Rule G-17.[9] In those cases where a municipal issuer designated counsel for the underwriter, the underwriter's liability may arise as a result of counsel's failure to reasonably perform an adequate investigation of the due diligence issues delegated to counsel.

The MSRB's concern about the practice is heightened in light of the increasing responsibility of underwriters and underwriter's counsel. Since the MSRB issued the 1998 Notice, the role of underwriters and their counsel has grown. For example, the SEC's 2014 Municipalities Continuing Disclosure Cooperation (MCDC) initiative underscores the potential hazards for underwriters and issuers stemming from inadequate due diligence, and makes clear that an underwriter's due diligence obligations are, in many respects, quite broad in scope. The actions brought against underwriters focused, among other things, on the obligation of underwriters and their counsel to undertake a thorough review of the issuer's history of disclosure compliance under Exchange Act Rule 15c2-12.[10] Underwriters that rely on issuer-designated underwriter's counsel to look back five years and verify issuers' history of disclosure compliance may expose themselves to the risk of very substantial financial penalties.[11] As regulatory scrutiny of disclosure

[9] An underwriter may be charged in federal district court or in an SEC administrative proceeding with violating the anti-fraud provisions set forth in Section 17(a) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934. In addition, investors may bring a civil action based upon the antifraud provisions in Exchange Act Section 10(b) and Exchange Act Rule 10b-5.

[10] Through the MCDC initiative, the SEC settled with 72 underwriters for violations of the federal securities laws related to representations about issuers' past compliance with continuing disclosure obligations in bond offering documents. Securities and Exchange Commission, *SEC MCDC Enforcement Initiative Update: SEC Announces Final Actions against Municipal Bond Underwriters and Beginning of an Issuer Sweep* (2016), available at http://www.haynesboone.com/alerts/2016/02/23/sec-mcdc-enforcement-initiative-update-sec-announces.

[11] The financial penalties under the MCDC initiative ranged from $20,000 to a maximum of $500,000. Penalties imposed in cases where violations are not self-reported, as they were in the MCDC initiative, could be even higher.

practices continues, the complexity and breadth of an underwriter's due diligence responsibilities may increase further.[12]

In the years since the MSRB publicized its concern regarding issuer designation of counsel, other organizations, representing issuers and other market participants, have also voiced their concerns regarding the practice, or, more generally, the resulting conflicts of interest.[13] Certain stakeholders have suggested best practices. The GFOA published best practices in 2009, which recommended alternatives preferable to the practice of issuer designation of counsel.[14] SIFMA released best practice recommendations in March 2013, urging disclosure of the role of the issuer in the selection of underwriter's counsel.[15]

MSRB Recommendations

Despite the concerns raised by the MSRB and market participants, issuer designation of counsel continues as a common practice in the municipal

[12] For example, the SEC recently proposed to amend Exchange Act Rule 15c2-12 to add two events to those events that require an issuer to provide notice in writing to the SEC within 10 business days of the occurrence of the event. The proposed additional "events" are broadly identified to include: (i) the incurrence of a financial obligation of the issuer or another obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, if any of which affect security holders, if material; and (ii) other events, such as a default or an event of acceleration and similar events that reflect financial difficulty of the issuer or any other obligated person. Securities Exchange Act Release No. 80130 (March 1, 2017), 82 FR 13928 (March 15, 2017) (File No. S7-01-17). If the proposed amendments to Exchange Act Rule 15c2-12 are approved, an underwriter's due diligence obligations will increase to monitor whether an issuer's prior disclosures refer to such events, and underwriter's counsel may be asked to assist in this review.

[13] *See 2009 GFOA Statement*; SIFMA, *Best Practice Recommendation on Disclosures Regarding Choice of Underwriters' Counsel in Municipal Securities Transactions* (March 2013) ("*SIFMA Best Practice Recommendation*"). *See also* New York State Bar Association, *Ethics Opinion 818* (2007), *available at* https://www.nysba.org/CustomTemplates/Content.aspx?id=5226 ("Ethics Opinion"); and National Federation of Municipal Analysts, *NFMA White Paper on the Disclosure of Potential Conflicts of Interest in Municipal Finance Transactions* (August 2015), *available at* http://www.nfma.org/assets/documents/RBP/wp_conflictsofinterest_final82015.pdf.

[14] *See 2009 GFOA Statement*.

[15] *See SIFMA Best Practice Recommendation*.

securities market.[16] The MSRB is responding to the continuation of this practice with this market advisory to restate the MSRB's concerns that investors may be harmed in a variety of ways in any offering process that does not properly utilize the review, guidance and counseling of an independent, competent and appropriately critical underwriter's counsel. Further, for the protection of market integrity, investors, issuers and underwriters, the MSRB believes that issuers should not designate underwriter's counsel in light of the conflicts of interest this practice may give rise to, and underwriters must be free to select their own counsel and to reject the imposition of counsel in circumstances where they lack the basis for placing their complete confidence in such counsel. To minimize conflicts of interest and to reduce any influence by an issuer that may call into question the qualifications or independence of the underwriter's counsel, the MSRB suggests that an issuer refrain from involving itself in the underwriter's selection of counsel or that an issuer's involvement in such process be minimal and limited to concerns regarding competency, conflicts of interest and the avoidance of excessive costs.

[16] In 2013, SIFMA reported receiving anecdotal reports from underwriters of an increase in issuers' involvement in the selection of underwriter's counsel. Glazier, K., "SIFMA Issues Paper Urging Underwriters to Disclose Issuer Designation of their Counsel," The Bond Buyer (2013), *available at* *http://www.bondbuyer.com/issues/122_60/sifma-issues-best-practice-paper-recommending-underwriters-disclose-counsel-1050134-1.html.* Recent news reports indicate that the practice continues in the municipal market as well as other financial markets. Sorkin, A.R., "A Growing Conflict in Wall St. Buyouts," The New York Times (2016), *available at* *https://www.nytimes.com/2016/01/05/business/dealbook/a-growing-conflict-in-wall-st-buyouts.html?_r=1*.