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Business Law Section
Securities Regulation Committee

March 12, 2014

Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1900 Duke Street
Suite 600
Alexandria, VA 22314

Re : Regulatory Notice 2014-01
Request for Comment on Draft MSRB
Rule G-42, on Duties of Non-Solicitor
Municipal Advisors

The Securities Regulation Committee of the Business Law Section of the New York State Bar Association appreciates the invitation from the Municipal Securities Rulemaking Board ("MSRB" or "Board") in Regulatory Notice 2014-01 to comment on the MSRB's draft Rule G-42 (Duties of Non-Solicitor Municipal Advisors).

The Committee is composed of members of the New York State Bar Association, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and corporation law departments. A draft of this letter was reviewed by certain members of the Committee. The views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association or its Business Law Section.

Introduction

As the SEC noted in the release adopting final rules for municipal advisors (SEC Release No. 34-70462[1])("Adopting Release"), citing the Senate report related to the Dodd-Frank Act, the

[1] www.sec.gov/rules/final/2013/34-70462.pdf.

municipal securities market has been significantly less regulated than the corporate securities market, and during the financial crisis a number of municipalities suffered losses from complex derivatives products marketed by unregulated financial intermediaries.[2] We support the efforts of Congress and the SEC to regulate those financial intermediaries as municipal advisors, and we generally support the Board's effort to impose standards of conduct on municipal advisors. However, we would like to use this opportunity to point out ways in which the proposed standards in draft Rule G-42 will have a disparate impact on different types of municipal advisors, and to suggest possible solutions.

The definition of "municipal advisor" in Section 15B(e) of the Securities Exchange Act of 1934 ("Exchange Act"), as interpreted by the Securities and Exchange Commission ("SEC"), encompasses a wide variety of persons and activities. At the core of the definition are persons that advise municipal entities on the issuance of municipal securities or act as intermediaries or finders between municipal entities and municipal underwriters.

But the definition also includes persons that advise municipal entities and obligated persons with respect to municipal financial products – municipal derivatives, guaranteed investment contracts and investment strategies. Investment strategies include plans or programs for the investment of the proceeds of municipal securities. Significantly, the SEC, in Adopting Release, announced changes to its interpretation of the term "investment strategies" such that the adviser to a collective pool that commingles proceeds of municipal securities with funds from other investors is a municipal advisor unless it is exempt as an SEC-registered investment adviser.[3] Fund advisers that will be required to register as municipal advisors if proceeds of municipal securities have been invested in their collective pools include banks and trust companies, which are excluded from the definition of investment adviser (and, therefore, not registered), state-registered investment advisers, exempt reporting advisers, foreign private advisers and advisers to real estate funds. We believe that the number of fund managers and advisers required to register as municipal advisors will be greater than the number estimated by the SEC for purposes of its Paperwork Reduction Act analysis.[4]

The definition of municipal advisor as interpreted by the SEC may also include other categories of persons who may not consider themselves to be in the business of acting as municipal advisors, including providers of guaranteed investment contracts and counterparties in municipal derivatives. If those persons provide advice about their products, in addition to selling them, they may be considered municipal advisors.

As discussed below, we believe that Rule G-42, as drafted, imposes requirements that do not comport with the businesses of some non-solicitor municipal advisors, and may conflict with or add unnecessarily to similar requirements imposed by other regulators. For that reason, we recommend that G-42 be re-proposed as a series of principles that can be applied by each municipal advisor in a manner appropriate to its business. In the alternative, if the MSRB determines to proceed with the Rule substantially as proposed, we recommend that it be revised

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2 Adopting Release text at n. 3.

3 Adopting Release, text at n. 398.

4 The SEC counted only state-registered investment advisers. See Adopting Release, n. 1621 and associated text.

to provide sufficient flexibility to allow municipal advisors to adapt the requirements of the Rule to their businesses.

Comments on Provisions of Draft Rule G-42

Duty of Care. Section (a) of the Rule imposes a duty of care on municipal advisors to clients that are either obligated persons or municipal entities. The elements of the duty of care are described in Supplementary Material .01. Among other things, a municipal advisor that is engaged by a client in connection with "a municipal financial product that is related to an issuance of municipal securities must also undertake a thorough review of the official statement for that issue, unless otherwise directed by the client and documented under subsection (c)(iv)" of the Rule.

Collective investment pools or funds may constitute investment strategies and, therefore, municipal financial products, if a municipal entity has invested proceeds of an issuance of municipal securities in the fund, even if the money invested by the municipal entity only represents a small percentage of the total amount invested in the fund by all participants. In our view, unless a municipal advisor that operates an investment fund has specifically advised a municipal entity investing in the fund with respect to a particular issuance of municipal securities included in the fund, the municipal advisor should not be required to undertake a review of the offering statement for the issuance of the municipal securities and should not be required to specifically obtain a reduction in the scope of its duties under subsection (c)(iv) for this purpose.

State and local retirement funds are significant investors in investment funds, including real estate investment funds and collective pools managed by banks or trust companies. The fund industry is awaiting advice from the SEC as to whether proceeds of municipal securities are deemed to be "spent," and thus no longer considered to be proceeds of municipal securities, when deposited in a state or local retirement fund. If proceeds of municipal securities are not deemed to be spent when they are deposited in a state or local retirement fund, then all future investments by such a retirement fund that has ever received the proceeds of municipal securities may be considered proceeds of municipal securities. We understand that some large state retirement systems also manage the money of local retirement funds. Such state systems may be unable to trace money that they have invested with privately managed investment funds to a particular issuance of municipal securities. In such circumstances, the municipal entity arguably would have no reasonable expectation that the fund manager's duty of care will include review of an offering statement. Thorough review of an offering statement should only be an element of the duty of care when the offering statement is relevant to the nature of the transaction for which the municipal advisor is providing advice.

Duty of Loyalty. Supplementary Material .02, which discusses the elements of the duty of loyalty, states: "[A] municipal advisor must investigate or consider other reasonably feasible alternatives to any recommended municipal securities transaction or municipal securities product that might also or alternatively serve the municipal client's objectives." We do not support this element of the duty of loyalty generally and as applied to specific types of businesses.

As a general matter, the duty of the municipal advisor to consider other reasonably feasible alternatives to a recommended transaction or product should apply only when it is within the explicit or implicit scope of the engagement, and not in other cases. Unlike Supplementary Material .01, Supplementary Material .02 does not permit an element of the duty to be carved out of the scope of engagement by direction of the client and documented pursuant to subsection (c)(iv). In many cases a municipal advisor's engagement may not, explicitly or implicitly, contemplate that the advisor will present to the client other reasonably feasible alternatives to a recommended transaction. Accordingly, we believe that client direction and documentation should not be required in any case where this element of the duty of loyalty is not within the explicit or implicit scope of the engagement.

The duty to consider other reasonably feasible alternatives is particularly inapposite where the municipal advisor is simply selling a product, and is not acting as advisor. Imposing a duty on a fund advisor selling a product to a municipal entity to investigate whether another fund or product would be a better alternative for the prospective investor would be inconsistent with the role of the fund advisor and with the expectations of the municipal client and would impose an unnecessary and inappropriate burden on the fund advisor. Similarly, sellers of GICs and swaps counterparties should not be required to investigate and recommend the products of other sellers or counterparties. Municipal advisors should not, of course, sell inferior or overpriced products or services to municipal entities, but that duty is different from the duty to investigate and propose to municipal clients other alternatives to their own products.

Application of Duties of Care and Loyalty to Fund Investors. Municipal advisors that manage or advise investment funds in which municipal entities have invested should not have a different or greater duty of loyalty or care to the municipal entities in the funds than their duties to other investors in the fund, in the absence of an agreement among the fund investors and the municipal advisor to the contrary.

Disclosure of Conflicts of Interest and Other Information. Section (b) of the Rule requires the municipal advisor, at or prior to the inception of the municipal advisory relationship, to provide the client with a document disclosing certain material conflicts of interest. When the municipal advisory relationship is the result of an investment by the municipal entity or obligated person in a fund managed or advised by the municipal advisor and including investments by other persons, the municipal advisor should be deemed to have satisfied this requirement by the use of an offering document provided to all investors and disclosing conflicts of interest that are relevant to fund investors generally.

We do not support a requirement that a municipal advisor with no material conflicts of interest provide written documentation to the client to that effect. In particular, we do not believe the Board should impose a requirement for a municipal advisor to list each of the categories of conflict and to state that there are none, or that there are none other than those listed. Absent any disclosable conflicts, the required disclosure would provide no meaningful information to investors. Moreover, were an advisor to provide a long, boilerplate list of potential conflicts, whether or not material, there exists a real possibility of over-disclosure and client confusion. We believe that clients are better served by a shorter list of material conflicts.

Documentation of Municipal Advisory Relationship. Section (c) requires a municipal advisor to "evidence each of its municipal advisory relationships by a writing entered into prior to, upon or promptly after the inception of the municipal advisory relationship" and prescribes what the writing must contain. In our view, a fund manager or adviser that provides offering material to investors in its fund and obtains executed subscription agreements or other organizational agreements should not be required to provide separate writings to fund investors that are municipal entities or obligated persons. Rule G-42 should permit the written documentation to contain information that is appropriate to an investor in the fund and not specific to a municipal advisory relationship.

In particular, the fund manager or adviser should not be required to (1) identify each investor in the fund that is a municipal entity or obligated person, (2) enter into a separate agreement with each municipal entity or obligated person or (3) assume obligations with respect to investors that are municipal entities or obligated persons that are different from the obligations to investors generally, except in the situation where the municipal advisor enters into a separate account relationship with a municipal entity or obligated person and recommends investment in a fund managed or advised by the municipal advisor as part of the client's overall investment strategy.

Recommendations. Section (d) discusses the suitability obligations of a municipal advisor making a recommendation to a client. We urge the Board to distinguish between a recommendation to invest in an investment fund and investment choices that are made by the adviser to the fund. The provisions of Section (d) should not apply to the investment choices made for the fund as a whole.

With respect to the decision to invest in the investment fund, the adviser to the fund should have a limited suitability obligation in cases where the municipal entity or obligated person is represented or introduced by a person with its own suitability or fiduciary obligation, such as a registered broker, a state or federally registered investment adviser or another registered municipal advisor. If the municipal entity or obligated person acknowledges in writing that it is relying on the recommendations of a qualified person and not on the recommendations of the fund adviser, the fund adviser should not be subject to the suitability requirements of section (d) or Supplementary Material .08.

Prohibition on Principal Transactions. Section (f) provides: "[e]xcept for an activity that is expressly permitted under Rule G-23, a municipal advisor, and any affiliate of a municipal advisor, is prohibited from engaging in any transaction, in a principal capacity, to which a municipal entity or obligated person client of the municipal advisor is a counterparty." We appreciate the purpose of this prohibition in situations where the municipal advisor is acting primarily in the role of adviser. However, the prohibition on principal transactions is not compatible with situations in which a person is deemed to be a municipal advisor by reason of providing a GIC or acting as a counterparty in a municipal derivative transaction. This may occur if the person's advice to the municipal entity is solely incidental to providing the product.[5] Section (f) should be amended to distinguish between situations where the municipal advisor is functioning primarily as an adviser and situations where it is acting as principal in a transaction

[5] The Rule G-23 exception does not address this issue.

with the client and providing advice only secondarily. At a minimum, the prohibition should not apply in situations where the client is advised by another municipal advisor in connection with the transaction.[6]

Specified Prohibitions – Payments to Others for Obtaining Business. Subsection (g)(v) prohibits "making payments for the purpose of obtaining or retaining municipal advisory business other than reasonable fees paid to another municipal advisor registered as such with the [SEC] and the Board for a solicitation of a municipal entity or obligated person as described in Section 15B(e)(9) of the Act." Section 15B(e)(9) by its terms does not require registration as a municipal advisor of an affiliated person that solicits on behalf of a municipal entity. In addition, in the Adopting Release, the SEC provided guidance that a broker-dealer that solicits municipal entities or obligated persons to invest in a fund advised by a municipal advisor or investment adviser is not a solicitor within the meaning of Section 15B(e)(9).[7] The exception in Subsection (g)(v) for payments to registered municipal advisors is, therefore, too narrow, because it would bar payments to broker-dealers and affiliated entities of the municipal advisor. Section (g)(v) should be amended to permit payments to (1) persons subject to a comparable regulatory regime, including banks, trust companies, broker-dealers and investment advisers and (2) affiliates of the municipal advisor, provided that, in either case, the payments are disclosed to the client.

Advantages of Principles-Based Rule

We would support a principles-based version of Rule G-42 that sets forth the requirements and prohibitions of the current draft Rule as principles rather than as prescriptive requirements, and requires municipal advisors to establish policies and procedures that address those principles in a manner that is appropriate to the municipal advisor's business. A principles-based rule would provide the flexibility to permit municipal advisors engaged in a broad range of businesses to adapt the principles in ways appropriate to those businesses.

Some registered municipal advisors are also subject to other regulatory requirements, including bank, broker-dealer and investment adviser regulation. In addition, the rules under the Employee Retirement Income Security Act (ERISA) are applicable to some registered municipal advisors -- for example, to managers or advisers to investment funds having municipal retirement systems as investors. For municipal advisors that are already subject to separate regulatory requirements that address the principles covered by Rule G-42, the Rule should deem compliance with the separate regulatory requirements to constitute compliance with the Rule, to the extent that both cover the same subject matter.

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We are grateful for the opportunity to provide these comments on the draft Rule and for the Board's attention and consideration. We hope that our comments, observations, and

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[6] By analogy, see SEC Rule 15Ba1-1(d)(3)(vi), which excludes from the definition of municipal advisor a person engaging in municipal advisory activities in circumstances where the municipal advisor or obligated person is otherwise represented by an independent registered municipal advisor with respect to the same aspects of a municipal financial product.

[7] Adopting Release, text following n. 460.

recommendations contribute to the important work of the Board in carrying out the regulatory initiatives under the Dodd-Frank. We would be happy to discuss these comments further with the Board and its staff.

Respectfully submitted,

SECURITIES REGULATION COMMITTEE

By: /s/
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