| OMB APPROVAL | |
|---|---|
| OMB Number: | 3235-0045 |
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*Required fields are shown with yellow backgrounds and asterisks.*

Page 1 of * 90

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No.* SR - 2011 - * 09
Amendment No. (req. for Amendments *)

Proposed Rule Change by Municipal Securities Rulemaking Board

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * ☒ Amendment * ☐ Withdrawal ☐

Section 19(b)(2) * ☒ Section 19(b)(3)(A) * ☐ Section 19(b)(3)(B) * ☐

Pilot ☐

Extension of Time Period for Commission Action * ☐

Date Expires *

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(2) ☐ 19b-4(f)(3) ☐ 19b-4(f)(4) ☐ 19b-4(f)(5) ☐ 19b-4(f)(6)

Exhibit 2 Sent As Paper Document ☐

Exhibit 3 Sent As Paper Document ☐

**Description**

Provide a brief description of the proposed rule change (limit 250 characters, required when Initial is checked *).

Proposed interpretive notice concerning the application of MSRB G-17, on conduct of municipal securities and municipal advisory activities, to underwriters of municipal securities

**Contact Information**

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name * Peg Last Name * Henry

Title * General Counsel, Market Regulation

E-mail * phenry@msrb.org

Telephone * (703) 797-6600 Fax (703) 797-6700

**Signature**

Pursuant to the requirements of the Securities Exchange Act of 1934,

Municipal Securities Rulemaking Board

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date 08/22/2011

By Ronald W. Smith
(Name *)

Corporate Secretary
(Title *)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Ronald Smith, rsmith@msrb.org

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

**Form 19b-4 Information (required)**

Add Remove View

The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change (required)**

Add Remove View

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

Add Remove View

Exhibit Sent As Paper Document ☐

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document ☐

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

Add Remove View

The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

Add Remove View

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

Add Remove View

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

## 1. Text of Proposed Rule Change

(a) The Municipal Securities Rulemaking Board (the "MSRB" or "Board") is hereby filing with the Securities and Exchange Commission (the "SEC" or "Commission") a proposed rule change consisting of a proposed interpretive notice (the "Notice") concerning the application of MSRB Rule G-17 (on conduct of municipal securities and municipal advisory activities) to underwriters of municipal securities. The MSRB requests that the proposed rule change be made effective 90 days after approval by the Commission.

The text of the proposed rule change is set forth below:[1]

* * *

**INTERPRETIVE GUIDANCE CONCERNING THE APPLICATION OF MSRB RULE G-17 TO UNDERWRITERS OF MUNICIPAL SECURITIES**

Under Rule G-17 of the Municipal Securities Rulemaking Board (the "MSRB"), brokers, dealers, and municipal securities dealers ("dealers") must, in the conduct of their municipal securities activities, deal fairly with all persons and must not engage in any deceptive, dishonest, or unfair practice. This rule is most often cited in connection with duties owed by dealers to investors; however, it also applies to their interactions with other market participants, including municipal entities.[1]

The MSRB has previously observed that Rule G-17 requires dealers to deal fairly with issuers in connection with the underwriting of their municipal securities.[2] More recently, with the passage of the Dodd-Frank Act,[3] the MSRB was expressly directed by Congress to protect municipal entities. Accordingly, the MSRB is providing additional interpretive guidance that addresses how Rule G-17 applies to dealers in the municipal securities transactions described below.

The examples discussed in this notice are illustrative only and are not meant to encompass all obligations of dealers to municipal entities under Rule G-17. The notice also does not address a dealer's duties when the dealer is serving as an advisor to a municipal entity or obligated person. Furthermore, when municipal entities are customers[4] of dealers they are subject to the same protections under MSRB rules, including Rule G-17, that apply to other customers.[5] The MSRB notes that an underwriter has a duty of fair dealing to investors in addition to its duty of fair dealing to issuers. An underwriter also has a duty to comply with other MSRB rules as well as other federal and state securities laws.

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1 Underlining indicates additions.

**Basic Fair Dealing Principle**

As noted above, Rule G-17 precludes a dealer, in the conduct of its municipal securities activities, from engaging in any deceptive, dishonest, or unfair practice with any person, including an issuer of municipal securities. The rule contains an anti-fraud prohibition. Thus, an underwriter must not misrepresent or omit the facts, risks, potential benefits, or other material information about municipal securities activities undertaken with a municipal issuer. However, Rule G-17 does not merely prohibit deceptive conduct on the part of the dealer. It also establishes a general duty of a dealer to deal fairly with all persons (including, but not limited to, issuers of municipal securities), even in the absence of fraud.

**Representations to Issuers**

All representations made by underwriters to issuers of municipal securities in connection with municipal securities underwritings, whether written or oral, must be truthful and accurate and must not misrepresent or omit material facts. Underwriters must have a reasonable basis for the representations and other material information contained in documents they prepare and must refrain from including representations or other information they know or should know is inaccurate or misleading. For example, in connection with a certificate signed by the underwriter that will be relied upon by the issuer or other relevant parties to an underwriting (e.g., an issue price certificate), the dealer must have a reasonable basis for the representations and other material information contained therein. In addition, an underwriter's response to an issuer's request for proposals or qualifications must fairly and accurately describe the underwriter's capacity, resources, and knowledge to perform the proposed underwriting as of the time the proposal is submitted and must not contain any representations or other material information about such capacity, resources, or knowledge that the underwriter knows or should know to be inaccurate or misleading. Matters not within the personal knowledge of those preparing the response (e.g., pending litigation) must be confirmed by those with knowledge of the subject matter. An underwriter must not represent that it has the requisite knowledge or expertise with respect to a particular financing if the personnel that it intends to work on the financing do not have the requisite knowledge or expertise.

**Required Disclosures to Issuers**

Many municipal securities are issued using financing structures that are routine and well understood by the typical municipal market professional, including most issuer personnel that have the lead responsibilities in connection with the issuance of municipal securities. For example, absent unusual circumstances or features, the typical fixed rate offering may be presumed to be well understood. Nevertheless, in the case of issuer personnel that lack knowledge or experience with such structures, the underwriter must provide disclosures on the material aspects of such structures.

However, in some cases, issuer personnel responsible for the issuance of municipal securities would not be well positioned to fully understand or assess the

implications of a financing in its totality, because the financing is structured in a unique, atypical, or otherwise complex manner (a "complex municipal securities financing").[6] Examples of complex municipal securities financings include variable rate demand obligations ("VRDOs") and financings involving derivatives (such as swaps). An underwriter in a negotiated offering that recommends a complex municipal securities financing to an issuer has an obligation under Rule G-17 to make more particularized disclosures than those that may be required in the case of routine financing structures. The underwriter must disclose all material risks and characteristics of the complex municipal securities financing.[7] It must also disclose any incentives for the underwriter to recommend the financing and other associated conflicts of interest.[8] Such disclosures must be made in a fair and balanced manner based on principles of fair dealing and good faith.

The level of disclosure required may vary according to the issuer's knowledge or experience with the proposed financing structure or similar structures, capability of evaluating the risks of the recommended financing, and financial ability to bear the risks of the recommended financing, in each case based on the reasonable belief of the underwriter.[9] In all events, the underwriter must disclose any incentives for the underwriter to recommend the complex municipal securities financing and other associated conflicts of interest.

The disclosures described in this notice must be made in writing to an official of the issuer whom the underwriter reasonably believes has the authority to bind the issuer by contract with the underwriter (i) in sufficient time before the execution of a contract with the underwriter to allow the official to evaluate the recommendation and (ii) in a manner designed to make clear to such official the subject matter of such disclosures and their implications for the issuer. The disclosures concerning a complex municipal securities financing must address the specific elements of the financing, rather than being general in nature. If the underwriter does not reasonably believe that the official to whom the disclosures are addressed is capable of independently evaluating the disclosures, the underwriter must make additional efforts reasonably designed to inform the official or its employees or agent.

**Underwriter Duties in Connection with Issuer Disclosure Documents**

Underwriters often play an important role in assisting issuers in the preparation of disclosure documents, such as preliminary official statements and official statements.[10] These documents are critical to the municipal securities transaction, in that investors rely on the representations contained in such documents in making their investment decisions. Moreover, investment professionals, such as municipal securities analysts and ratings services, rely on the representations in forming an opinion regarding the credit. A dealer's duty to have a reasonable basis for the representations it makes, and other material information it provides, to an issuer and to ensure that such representations and information are accurate and not misleading, as described above, extends to representations and information provided by the underwriter in connection with the preparation by the issuer of its disclosure documents (e.g., cash flows).

**Underwriter Compensation and New Issue Pricing**

**Excessive Compensation**. An underwriter's compensation for a new issue (including both direct compensation paid by the issuer and other separate payments or credits received by the underwriter from the issuer or any other party in connection with the underwriting), in certain cases and depending upon the specific facts and circumstances of the offering, may be so disproportionate to the nature of the underwriting and related services performed as to constitute an unfair practice with regard to the issuer that it is a violation of Rule G-17. Among the factors relevant to whether an underwriter's compensation is disproportionate to the nature of the underwriting and related services performed, are the credit quality of the issue, the size of the issue, market conditions, the length of time spent structuring the issue, and whether the underwriter is paying the fee of the underwriter's counsel or any other relevant costs related to the financing.

**Fair Pricing**. The duty of fair dealing under Rule G-17 includes an implied representation that the price an underwriter pays to an issuer is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value of the issue at the time it is priced.[11] In general, a dealer purchasing bonds in a competitive underwriting for which the issuer may reject any and all bids will be deemed to have satisfied its duty of fairness to the issuer with respect to the purchase price of the issue as long as the dealer's bid is a bona fide bid (as defined in Rule G-13)[12] that is based on the dealer's best judgment of the fair market value of the securities that are the subject of the bid. In a negotiated underwriting, the underwriter has a duty under Rule G-17 to negotiate in good faith with the issuer. This duty includes the obligation of the dealer to ensure the accuracy of representations made during the course of such negotiations, including representations regarding the price negotiated and the nature of investor demand for the securities (e.g., the status of the order period and the order book). If, for example, the dealer represents to the issuer that it is providing the "best" market price available on the new issue, or that it will exert its best efforts to obtain the "most favorable" pricing, the dealer may violate Rule G-17 if its actions are inconsistent with such representations.[13]

**Conflicts of Interest**

**Payments to or from Third Parties**. In certain cases, compensation received by the underwriter from third parties, such as the providers of derivatives and investments (including affiliates of the underwriter), may color the underwriter's judgment and cause it to recommend products, structures, and pricing levels to an issuer when it would not have done so absent such payments. The MSRB views the failure of an underwriter to disclose to the issuer payments, values, or credits received by the underwriter in connection with its underwriting of the new issue from parties other than the issuer, and payments made by the underwriter in connection with such new issue to parties other than the issuer (in either case including payments, values, or credits that relate directly or indirectly to collateral transactions integrally related to the issue being underwritten), to

be a violation of the underwriter's obligation to the issuer under Rule G-17.[14] For example, it would be a violation of Rule G-17 for an underwriter to compensate an undisclosed third party in order to secure municipal securities business. Similarly, it would be a violation of Rule G-17 for an underwriter to receive undisclosed compensation from a third party in exchange for recommending that third party's services or product to an issuer, including business related to municipal securities derivative transactions. The underwriter must disclose to the issuer the amount paid or received, the purpose for which such payment was made and the name of the party making or receiving such payment. The underwriter must also disclose to the issuer the details of any third-party arrangements for the marketing of the issuer's securities.

**Profit-Sharing with Investors**. Arrangements between the underwriter and an investor purchasing new issue securities from the underwriter (including purchases that are contingent upon the delivery by the issuer to the underwriter of the securities) according to which profits realized from the resale by such investor of the securities are directly or indirectly split or otherwise shared with the underwriter also would, depending on the facts and circumstances (including in particular if such resale occurs reasonably close in time to the original sale by the underwriter to the investor), constitute a violation of the underwriter's fair dealing obligation under Rule G-17. Such arrangements could also constitute a violation of Rule G-25(c), which precludes a dealer from sharing, directly or indirectly, in the profits or losses of a transaction in municipal securities with or for a customer.

**Credit Default Swaps**. The issuance or purchase by a dealer of credit default swaps for which the reference is the issuer for which the dealer is serving as underwriter, or an obligation of that issuer, may pose a conflict of interest, because trading in such municipal credit default swaps has the potential to affect the pricing of the underlying reference obligations, as well as the pricing of other obligations brought to market by that issuer. Rule G-17 requires, therefore, that a dealer that engages in such activities disclose that to the issuers for which it serves as underwriter. Trades in credit default swaps based on baskets or indexes of municipal issuers that include the issuer or its obligation(s) need not be disclosed, unless the issuer or its obligation(s) represents more than 2% of the total notional amount of the credit default swap or the underwriter otherwise caused the issuer or its obligation(s) to be included in the basket or index.

## Retail Order Periods

Rule G-17 requires an underwriter that has agreed to underwrite a transaction with a retail order period to, in fact, honor such agreement.[15] A dealer that wishes to allocate securities in a manner that is inconsistent with an issuer's requirements must not do so without the issuer's consent. In addition, Rule G-17 requires an underwriter that has agreed to underwrite a transaction with a retail order period to take reasonable measures to ensure that retail clients are bona fide. An underwriter that knowingly accepts an order that has been framed as a retail order when it is not (e.g., a number of small orders placed by an institutional investor that would otherwise not qualify as a retail customer) would violate Rule G-17 if its actions are inconsistent with the issuer's expectations regarding

retail orders. In addition, a dealer that places an order that is framed as a qualifying retail order but in fact represents an order that does not meet the qualification requirements to be treated as a retail order (e.g., an order by a retail dealer without "going away" orders[16] from retail customers, when such orders are not within the issuer's definition of "retail") violates its Rule G-17 duty of fair dealing. The MSRB will continue to review activities relating to retail order periods to ensure that they are conducted in a fair and orderly manner consistent with the intent of the issuer and the MSRB's investor protection mandate.

**Dealer Payments to Issuer Personnel**

Dealers are reminded of the application of MSRB Rule G-20, on gifts, gratuities, and non-cash compensation, and Rule G-17, in connection with certain payments made to, and expenses reimbursed for, issuer personnel during the municipal bond issuance process.[17] These rules are designed to avoid conflicts of interest and to promote fair practices in the municipal securities market.

Dealers should consider carefully whether payments they make in regard to expenses of issuer personnel in the course of the bond issuance process, including in particular, but not limited to, payments for which dealers seek reimbursement from bond proceeds or issuers, comport with the requirements of Rule G-20. For example, a dealer acting as a financial advisor or underwriter may violate Rule G-20 by paying for excessive or lavish travel, meal, lodging and entertainment expenses in connection with an offering (such as may be incurred for rating agency trips, bond closing dinners, and other functions) that inure to the personal benefit of issuer personnel and that exceed the limits or otherwise violate the requirements of the rule.[18]

_____ __, 2011

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[1] The term "municipal entity" is defined by Section 15B(e)(8) of the Securities Exchange Act (the "Exchange Act") to mean: "any State, political subdivision of a State, or municipal corporate instrumentality of a State, including—(A) any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities."

[2] See Reminder Notice on Fair Practice Duties to Issuers of Municipal Securities, MSRB Notice 2009-54 (September 29, 2009); Rule G-17 Interpretive Letter – Purchase of new issue from issuer, MSRB interpretation of December 1, 1997, reprinted in MSRB Rule Book ("1997 Interpretation").

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 975, 124 Stat. 1376 (2010).

[4] MSRB Rule D-9 defines the term "customer" as follows: "Except as otherwise specifically provided by rule of the Board, the term "Customer" shall mean any person other than a broker, dealer, or municipal securities dealer acting in its capacity as such or an issuer in transactions involving the sale by the issuer of a new issue of its securities."

[5] See MSRB Reminds Firms of Their Sales Practice and Due Diligence Obligations When Selling Municipal Securities in the Secondary Market, MSRB Notice 2010-37 (September 20, 2010).

[6] If a complex municipal securities financing consists of an otherwise routine financing structure that incorporates a unique, atypical or complex element and the issuer has knowledge or experience with respect to the routine elements of the financing, the disclosure of material risks and characteristics may be limited to those relating to such specific element and any material impact such element may have on other features that would normally be viewed as routine.

[7] For example, an underwriter that recommends a VRDO should inform the issuer of the risk of interest rate fluctuations and material risks of any associated credit or liquidity facilities (e.g., the risk that the issuer might not be able to replace the facility upon its expiration and might be required to repay the facility provider over a short period of time). As an additional example, if the underwriter recommends that the issuer swap the floating rate interest payments on the VRDOs to fixed rate payments under an integrally-related swap and the underwriter or an affiliate of the underwriter is proposed to be the executing swap dealer, the underwriter must disclose the material risks (including market, credit, operational, and liquidity risks) and characteristics of the integrally-related swap, as well as the risks associated with the VRDO. Such disclosure should be sufficient to allow the issuer to assess the magnitude of its potential exposure as a result of the complex municipal securities financing. If the underwriter's affiliated swap dealer is proposed to be the executing swap dealer, the underwriter may satisfy its disclosure obligation with respect to the swap if such disclosure has been provided to the issuer by the affiliated swap dealer or the issuer's swap or other financial advisor that is independent of the underwriter and the swap dealer, as long the underwriter has a reasonable basis for belief in the truthfulness and completeness of such disclosure. The MSRB notes that dealers that recommend swaps or security-based swaps to municipal entities may also be subject to rules of the Commodity Futures Trading Commission or those of the Securities and Exchange Commission.

[8] For example, a conflict of interest may exist when the underwriter is also the provider of a swap used by an issuer to hedge a municipal securities offering or when the underwriter receives compensation from a swap provider for

recommending the swap provider to the issuer. See also "Conflicts of Interest/Payments to or from Third Parties" herein.

[9] Even a financing in which the interest rate is benchmarked to an index that is commonly used in the municipal marketplace (e.g., LIBOR or SIFMA) may be complex to an issuer that does not understand the components of that index or its possible interaction with other indexes.

[10] Underwriters that assist issuers in preparing official statements must remain cognizant of their duties under federal securities laws. With respect to primary offerings of municipal securities, the SEC has noted, "By participating in an offering, an underwriter makes an implied recommendation about the securities." See SEC Rel. No. 34-26100 (Sept. 22, 1988) (proposing Exchange Act Rule 15c2-12) at text following note 70. The SEC has stated that "this recommendation itself implies that the underwriter has a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings." Furthermore, pursuant to SEC Rule 15c2-12(b)(5), an underwriter may not purchase or sell municipal securities in most primary offerings unless the underwriter has reasonably determined that the issuer or an obligated person has entered into a written undertaking to provide certain types of secondary market disclosure and has a reasonable basis for relying on the accuracy of the issuer's ongoing disclosure representations. SEC Rel. No. 34-34961 (Nov. 10, 1994) (adopting continuing disclosure provisions of Exchange Act Rule 15c2-12) at text following note 52.

[11] The MSRB has previously observed that whether an underwriter has dealt fairly with an issuer for purposes of Rule G-17 is dependent upon all of the facts and circumstances of an underwriting and is not dependent solely on the price of the issue. See MSRB Notice 2009-54 and the 1997 Interpretation. See also "Retail Order Periods" herein.

[12] Rule G-13(b)(iii) provides: "For purposes of subparagraph (i), a quotation shall be deemed to represent a "bona fide bid for, or offer of, municipal securities" if the broker, dealer or municipal securities dealer making the quotation is prepared to purchase or sell the security which is the subject of the quotation at the price stated in the quotation and under such conditions, if any, as are specified at the time the quotation is made."

[13] See 1997 Interpretation.

[14] See also "Required Disclosures to Issuers" herein.

[15] See MSRB Interpretation on Priority of Orders for Securities in a Primary Offering under Rule G-17, MSRB interpretation of October 12, 2010, reprinted in MSRB Rule Book. The MSRB also reminds underwriters of previous MSRB guidance on the pricing of securities sold to retail investors. See Guidance on

Disclosure and Other Sales Practice Obligations to Individual and Other Retail Investors in Municipal Securities, MSRB Notice 2009-42 (July 14, 2009).

[16] In general, a "going away" order is an order for new issue securities for which a customer is already conditionally committed. See SEC Release No. 34-62715, File No. SR-MSRB-2009-17 (August 13, 2010).

[17] See MSRB Rule G-20 Interpretation — Dealer Payments in Connection With the Municipal Securities Issuance Process, MSRB interpretation of January 29, 2007, reprinted in MSRB Rule Book.

[18] See In the Matter of RBC Capital Markets Corporation, SEC Rel. No. 34-59439 (Feb. 24, 2009) (settlement in connection with broker-dealer alleged to have violated MSRB Rules G-20 and G-17 for payment of lavish travel and entertainment expenses of city officials and their families associated with rating agency trips, which expenditures were subsequently reimbursed from bond proceeds as costs of issuance); In the Matter of Merchant Capital, L.L.C., SEC Rel. No. 34-60043 (June 4, 2009) (settlement in connection with broker-dealer alleged to have violated MSRB rules for payment of travel and entertainment expenses of family and friends of senior officials of issuer and reimbursement of the expenses from issuers and from proceeds of bond offerings).

* * * * *

(b) Not applicable.

(c) Not applicable.

**2. Procedures of the Self-Regulatory Organization**

The proposed rule change was adopted by the MSRB at its May 19-20, 2011 and July 27-29, 2011 meetings. Questions concerning this filing may be directed to Peg Henry, General Counsel, Market Regulation, at 703-797-6600.

**3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

(a) With the passage of the Dodd-Frank Act, the MSRB was expressly directed by Congress to protect municipal entities. Accordingly, the MSRB is proposing to provide additional interpretive guidance that addresses how Rule G-17 applies to dealers in the municipal securities activities described below.

A more-detailed description of the provisions of the Notice follows:

**Representations to Issuers.** The Notice would provide that all representations made by underwriters to issuers of municipal securities in connection with municipal

securities underwritings (e.g., issue price certificates and responses to requests for proposals), whether written or oral, must be truthful and accurate and may not misrepresent or omit material facts.

**Required Disclosures to Issuers.** The Notice would provide that an underwriter of a negotiated issue that recommends a complex municipal securities transaction or product (e.g., a variable rate demand obligation with a swap) to an issuer has an obligation under Rule G-17 to disclose all material risks (e.g., in the case of a swap, market, credit, operational, and liquidity risks), characteristics, incentives, and conflicts of interest (e.g., payments received from a swap provider) regarding the transaction or product. Such disclosure would be required to be sufficient to allow the issuer to assess the magnitude of its potential exposure as a result of the complex municipal securities financing. In the case of routine financing structures, underwriters would be required to disclose the material aspects of the structures if the issuers did not otherwise have knowledge or experience with respect to such structures.

The disclosures would be required to be made in writing to an official of the issuer whom the underwriter reasonably believed had the authority to bind the issuer by contract with the underwriter (i) in sufficient time before the execution of a contract with the underwriter to allow the official to evaluate the recommendation and (ii) in a manner designed to make clear to such official the subject matter of such disclosures and their implications for the issuer. If the underwriter did not reasonably believe that the official to whom the disclosures were addressed was capable of independently evaluating the disclosures, the underwriter would be required to make additional efforts reasonably designed to inform the official or its employees or agent.[2]

**Underwriter Duties in Connection with Issuer Disclosure Documents.** The Notice would provide that a dealer's duty to have a reasonable basis for the representations it makes, and other material information it provides, to an issuer and to ensure that such representations and information are accurate and not misleading, as described above, extends to representations and information provided by the underwriter in connection with the preparation by the issuer of its disclosure documents (e.g., cash flows).

**New Issue Pricing and Underwriter Compensation**. The Notice would provide that the duty of fair dealing under Rule G-17 includes an implied representation that the price an underwriter pays to an issuer is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value

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[2] Section 4s(h)(5) of the Commodity Exchange Act requires that a swap dealer with a special entity client (including states, local governments, and public pension funds) must have a reasonable basis to believe that the special entity has an independent representative that has sufficient knowledge to evaluate the transaction and its risks, as well as the pricing and appropriateness of the transaction. Section 15F(h)(5) of the Exchange Act imposes the same requirements with respect to security-based swaps.

of the issue at the time it is priced. The Notice distinguishes the fair pricing duties of competitive underwriters (submission of bona fide bid based on dealer's best judgment of fair market value of securities) and negotiated underwriters (duty to negotiate in good faith). The Notice would provide that, in certain cases and depending upon the specific facts and circumstances of the offering, the underwriter's compensation for the new issue (including both direct compensation paid by the issuer and other separate payments or credits received by the underwriter from the issuer or any other party in connection with the underwriting) may be so disproportionate to the nature of the underwriting and related services performed, as to constitute an unfair practice that is a violation of Rule G-17.

**Conflicts of Interest**. The Notice would require disclosure by an underwriter of potential conflicts of interest, including third-party payments, values, or credits made or received, profit-sharing arrangements with investors, and the issuance or purchase of credit default swaps for which the underlying reference is the issuer whose securities the dealer is underwriting or an obligation of that issuer.

**Retail Order Periods.** The Notice would remind underwriters not to disregard the issuers' rules for retail order periods by, among other things, accepting or placing orders that do not satisfy issuers' definitions of "retail."

**Dealer Payments to Issuers.** Finally, the Notice would remind underwriters that certain lavish gifts and entertainment, such as those made in conjunction with rating agency trips, might be a violation of Rule G-17, as well as Rule G-20.

(b) The MSRB believes that the proposed rule change is consistent with Section 15B(b)(2) of the Securities Exchange Act ("Exchange Act"), which provides that:

> The Board shall propose and adopt rules to effect the purposes of this title with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers and advice provided to or on behalf of municipal entities or obligated persons by brokers, dealers, municipal securities dealers, and municipal advisors with respect to municipal financial products, the issuance of municipal securities, and solicitations of municipal entities or obligated persons undertaken by brokers, dealers, municipal securities dealers, and municipal advisors.

Section 15B(b)(2)(C) of the Exchange Act, provides that the rules of the MSRB shall:

> be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities and municipal financial products, to remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in

general, to protect investors, municipal entities, obligated persons, and the public interest.

The proposed rule change is consistent with Section 15B(b)(2) of the Exchange Act because it will protect issuers of municipal securities from fraudulent and manipulative acts and practices and promote just and equitable principles of trade, while still emphasizing the duty of fair dealing owed by underwriters to their customers. Rule G-17 has two components, one an anti-fraud prohibition, and the other a fair dealing requirement (which promotes just and equitable principles of trade). The Notice would address both components of the rule. The sections of the Notice entitled "Representations to Issuers," "Underwriter Duties in Connection with Issuer Disclosure Documents," "Excessive Compensation," "Payments to or from Third Parties," "Profit-Sharing with Investors," "Retail Order Periods," and "Dealer Payments to Issuer Personnel" primarily would provide guidance as to conduct required to comply with the anti-fraud component of the rule and, in some cases, conduct that would violate the anti-fraud component of the rule, depending on the facts and circumstances. The sections of the Notice entitled "Required Disclosures to Issuers," "Fair Pricing," and "Credit Default Swaps" primarily would provide guidance as to conduct required to comply with the fair dealing component of the rule.

**4. Self-Regulatory Organization's Statement on Burden on Competition**

The MSRB does not believe that the proposed rule change would impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, since it would apply equally to all underwriters of municipal securities.

**5. Self-Regulatory Organization's Statement on Comments Received on the Proposed Rule Change by Members, Participants, or Others.**

On February 14, 2011, the MSRB requested comment on the proposed rule change.[3] The MSRB received comment letters from the American Federation of State, County and Municipal Employees ("AFSCME"); the Bond Dealers of America ("BDA"); Municipal Regulatory Consulting LLC ("MRC"); the National Association of Independent Public Finance Advisors ("NAIPFA"); and the Securities Industry and Financial Markets Association ("SIFMA").[4] The comments are summarized according to the subject headings of the Notice.

**Representations to Issuers**

- **Comments: Reasonable Basis for Certificates.** SIFMA said that the MSRB should reconsider the requirement for an underwriter to have a reasonable basis

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[3] See MSRB Notice 2011-12 (February 14, 2011).

[4] See Exhibit 2.

for the representations and material information in certificates it provides, arguing that other regulatory requirements (e.g., IRC Section 6700 and wire fraud statutes) already govern such representations. It said that the MSRB should, at least, confirm that an underwriter would meet this obligation when it verifies the information in the certificate against the official books of the issuer and any other factual information within the underwriter's control.

**MSRB Response:** The MSRB has determined to make no change to this requirement of the Notice and notes that the "reasonable basis" requirement of the Notice in the context of certificates provided by an underwriter is consistent with the view of the Commission that the underwriter must have a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in an offering of municipal securities. See endnote 10 to the Notice. It is also consistent with Internal Revenue Service interpretations of Section 6700 of the Internal Revenue Code, which address the application of the penalty to statements (including underwriter certificates) material to tax exemption that the maker knew or had "reason to know" were false or fraudulent, such as the one cited in note 9 to SIFMA's comment letter. Therefore, the Notice imposes no additional requirement upon underwriters.

Review of the official books of the issuer and other factual information within the underwriter's control may assist the underwriter in forming a reasonable basis for its certificate. However, if the certificate relies on the representations of others or facts not within the underwriter's control, additional due diligence on the part of the underwriter may be required. The MSRB notes that a quote from the Internal Revenue Service publication cited in SIFMA's letter provides some useful guidance on the level of inquiry required: "Participants [in a bond financing] can rely on matters of fact or material provided by other participants necessary to make their own statements or draw their own conclusions, unless they have actual knowledge or a reason to know of its inaccuracy or the statement is not credible or reasonable on its face." The Internal Revenue Service summarized the legislative history of Section 6700. See H. Conf. Rep. No. 101-247, 101st Cong., 1st Sess. 1397.

**Required Disclosures to Issuers**

- **Comments: Complex Financings.** SIFMA argued that more guidance is needed on the complex municipal securities financings requirements.

    - It said that a transaction should only be deemed complex if the municipal issuer informed the underwriter that the issuer had never engaged in the type of transaction before and therefore might not understand the transaction's material risks and characteristics.

    - It also said that the MSRB should provide more guidance and definition with regard to what types of transactions will be considered "complex,"

arguing that references to "external index not typically used in the municipal securities market" and "atypical or complex arrangements" were vague.

- It also said that issuers that required an analysis of the risks and characteristics of a transaction should hire independent advisors or separately contract for this service with their underwriters.

**MSRB Response:** In response to SIFMA's first comment above, the MSRB has added the following language to the Notice: "The level of disclosure required may vary according to the issuer's knowledge or experience with the proposed financing structure or similar structures, capability of evaluating the risks of the recommended financing, and financial ability to bear the risks of the recommended financing, in each case based on the reasonable belief of the underwriter." This language is based on the suitability analysis required by the Financial Industry Regulatory Authority ("FINRA") of dealers selling complex products, such as options and securities futures,[5] although the Notice does not go so far as to impose a suitability requirement on underwriters of municipal securities with respect to issuers.[6] The MSRB notes that this language applies only to disclosures concerning material terms and characteristics of a complex municipal securities financing. The Notice also provides: "In all events, the underwriter must disclose any incentives for the underwriter to recommend the complex municipal securities financing and other associated conflicts of interest." The MSRB does not agree with SIFMA that an issuer should be required to exercise its supposed "bargaining power" in order to receive such disclosures.

In response to SIFMA's second comment above, the Notice does provide examples of complex municipal securities financings: "variable rate demand obligations ("VRDOs") and financings involving derivatives (such as swaps)." In response to SIFMA's comment, the Notice now also distinguishes those examples from: "the typical fixed rate offering." It also now provides that: "Even a financing in which the interest rate is benchmarked to an index that is commonly

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5 FINRA Rules 2360 and 2370.

6 The Notice does not address whether engaging in any of the activities described in the Notice would cause a dealer to be considered a "municipal advisor" under the Exchange Act and the rules promulgated thereunder and, therefore, subject to a fiduciary duty. The MSRB notes that dealers that recommend swaps or security-based swaps to municipal entities may also be subject to rules of the Commodity Futures Trading Commission or those of the SEC. See, e.g., Federal Register Vol. 75, No. 245 (December 22, 2010) and Federal Register Vol. 76, No. 137 (July 18, 2011).

used in the municipal marketplace (e.g., LIBOR or SIFMA) may be complex to an issuer that does not understand the components of that index or its possible interaction with other indexes."

With regard to SIFMA's third comment, while the MSRB agrees that an issuer seeking an independent assessment of the risks and characteristics of a transaction recommended by an underwriter may wish to hire a separate municipal advisor for that purpose, at its own election, the MSRB is firmly of the view that basic principles of fair dealing require an underwriter to disclose the risks and characteristics of a complex municipal securities financing that it has itself determined to recommend to the issuer.

The MSRB notes that the Notice has been amended to provide that, in the case of routine financing structures, underwriters would be required to disclose the material aspects of the structures if the issuers did not otherwise have knowledge or experience with respect to such structures.

- **Comments: Recommendations.** NAIPFA argued that underwriters should also be required -- in the same manner and to the same extent as advisors would be required -- to have a reasonable basis for any recommendation they made and to disclose material risks about the course of conduct they recommend, along with the risks and potential benefits of reasonable alternatives then available in the market. SIFMA said that the MSRB should clarify whether a dealer's recommendation of a swap will subject it to a fiduciary duty. MRC said that the requirements for disclosures in the context of complex municipal securities financings should be set forth in Rule G-19.

  **MSRB Response:** The MSRB has determined not to impose a suitability duty in this context at this time. The Notice also does not address whether the provision of advice by underwriters will cause them to be considered municipal advisors under the Exchange Act and, accordingly, subject to a fiduciary duty. In the view of the MSRB, the duty of fair dealing is subsumed within a fiduciary duty, so additional duties may apply to the provision of advice by underwriters that the Commission considers to be municipal advisory activities. See also footnote 6 to this filing.

- **Comments: Recipients of Disclosures.** BDA and SIFMA said that an underwriter should only need to have a reasonable belief that it was making required disclosures to officials with the authority to bind the issuer, particularly if the official represented that he/she has such authority.

  **MSRB Response:** The MSRB agrees with this comment and has revised the Notice accordingly.

- **Comments: Timing of Disclosures.** SIFMA said that the MSRB should clarify that disclosures should only be required once. It said that, as an example, a

representation in a response to an RFP or otherwise before the underwriter is engaged should suffice.

**MSRB Response:** The Notice does not require disclosures to be made more than once per issue. An RFP response could be an appropriate place to make required disclosures as long as the proposed structure of the financing is adequately developed at that point to permit the disclosures required by the Notice.

**Underwriter Duties in Connection with Issuer Disclosure Documents**

- **Comments: Reasonable Basis for Official Statement Materials.** SIFMA argued that an underwriter should not be required to have a reasonable basis for the representations it makes, or other material information it provides in connection with the preparation by the issuer of its disclosure documents. Instead, SIFMA argued that the MSRB should permit an underwriter to agree with an issuer that the underwriter will only be responsible for materials furnished to an issuer if the underwriter has (i) consented, in writing, to such materials being used in offering documents and (ii) agreed with the issuer that the underwriter and not the issuer will assume responsibility for the accuracy and proper presentation of such material. SIFMA said that an underwriter should be able to limit its responsibility for information provided by disclosing to the issuer any limitations on the scope of its analysis and factual verification it performed. Furthermore, it argued that any duty should extend only to material information provided by the underwriter and not to all information and analysis, suggesting that an underwriter should not have to verify the assumptions and facts that underlie cash flows it prepared.

  **MSRB Response:** The MSRB does not agree with this comment and reminds SIFMA of the view of the SEC as summarized in endnote 10 to the Notice: With respect to primary offerings of municipal securities, the SEC has noted, "By participating in an offering, an underwriter makes an implied recommendation about the securities." See SEC Rel. No. 34-26100 (Sept. 22, 1988) (proposing Exchange Act Rule 15c2-12) at text following note 70 (the "1988 Proposing Release"). The SEC stated in the 1988 Proposing Release that "this recommendation itself implies that the underwriter has a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings." It would seem a curious result, therefore, for the underwriter not to be required under Rule G-17 to have a reasonable basis for its own representations set forth in the official statement, as well as a reasonable basis for the material information it provides to the issuer in connection with the preparation of the official statement, including a reasonable belief in the truthfulness and completeness of any information provided by others that serves as a material basis for such underwriter's information.

**Underwriter Compensation and New Issue Pricing**

- **Comments: Fair Pricing.** BDA said that the fair pricing obligation in the context of a new issue should employ a good faith standard. It said that there is no prevailing market price for new issues and that comparisons to secondary market trades are difficult because of the infrequency of trades and the differences among issuers. Similarly, SIFMA said that an underwriter should only be required to purchase securities at the price that it and the issuer negotiated and agreed to in good faith, without regard to a prevailing market price, which it said does not exist for new issue securities. It said that the MSRB's proposal will encourage increased reliance on credit ratings, which it characterized as contrary to the intent of Dodd-Frank and SEC policy guidance.

  **MSRB Response:** In response to this comment, the MSRB has amended the Notice to remove references to prevailing market price. Consistent with SIFMA's observation that many underwriters already make representations as to the fair market price of new issues in tax certificates to issuers, the Notice now reads: "The duty of fair dealing under Rule G-17 includes an implied representation that the price an underwriter pays to an issuer is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value of the issue at the time it is priced."

**Conflicts of Interest**

- **Comments: Conflicts Disclosure.** NAIPFA argued that underwriters should be required to comply with all the rules regarding conflicts to which municipal advisors would be subject under Rule G-17. Specifically, NAIPFA said that underwriters should be required to disclose with respect to all issues that they:

  - are not acting as advisors but as underwriters;
  - are not fiduciaries to the issuer but rather counterparties dealing at arm's-length;
  - have conflicts with issuers because they represent the interests of the investors or other counterparties, which may result in benefits to other transaction participants at direct cost to the issuer;
  - seek to maximize their profitability and such profitability may or may not be transparent or disclosed to the issuer; and
  - have no continuing obligation to the issuer following the closing of transactions.

  On the other hand, SIFMA argued that the Notice would impose a "fiduciary-lite" duty on underwriters, citing as examples the disclosures required of underwriters

recommending complex municipal securities financings and the required disclosures of business relationships and methods of doing business, including their financial incentives. It said that underwriters should not be required to make such disclosures as long as their failure to do so did not amount to false or fraudulent conduct.

**MSRB Response:** A number of NAIPFA's suggested disclosures were presented to the MSRB in connection with the MSRB's proposed amendments to Rule G-23 and were addressed by the MSRB in its filing with the SEC.[7] The MSRB's interpretive notice regarding Rule G-23 contained in that filing provides that a dealer will be considered to be acting as an underwriter for purposes of Rule G-23(b) if, among other things, it provides written disclosure to the issuer from the earliest stages of its relationship with the issuer that it is an underwriter and not a financial advisor and does not engage in a course of conduct that is inconsistent with arm's-length relationship with the issuer. The writing must make clear that the primary role of an underwriter is to purchase, or arrange for the placement of, securities in an arm's-length commercial transaction between the issuer and the underwriter and that the underwriter has financial and other interests that differ from those of the issuer. Rule G-17 is appropriately applied differently to market participants with different roles in a financing. Thus, for example, Rule G-17 may appropriately be interpreted to apply different standards of conduct to municipal advisors, which function as trusted advisors to municipal entities and obligated persons, than it does to underwriters of municipal securities, which are arm's-length counterparties to issuers of municipal securities, and dealers who solicit municipal entities on behalf of third-party clients.

Consistent with this interpretation of Rule G-17, the disclosures required by the Notice do not amount to the imposition of a fiduciary duty, whether "lite" or otherwise, on underwriters of municipal securities. Simple principles of fair dealing require that underwriters have more than a caveat emptor relationship with their issuer clients.

- **Comments: Payments to and from Third Parties.** BDA said that the MSRB should clarify what types of third party payments it was interested in and that they should not include tender option bond programs and similar arrangements. Alternatively, BDA said that generic disclosure should suffice. It argued that a requirement to disclose retail distribution and selling group arrangements was unnecessary because such arrangements were typically disclosed in official statements. In addition, SIFMA said that the MSRB should clarify the details of required disclosures and confirm that issuer consent to disclosures regarding third-party payments is not required. It argued that payments or internal credits among the underwriter and its affiliates should not be required to be disclosed. It made the same argument with respect to payments or other benefits received from

[7] See Amendment No. 1 to SR-MSRB-2011-03 (May 26, 2011). See also Exchange Act Release No. 64564 (May 27, 2011) (File No. SR-MSRB-2011-03).

collateral transactions, such as credit default swaps (CDS). While it argued that the proposed standard was inconsistent with SEC and FINRA requirements, it did not cite specific examples.

**MSRB Response:** The MSRB believes that issuers of municipal securities should be apprised of payments, values, or credits made to underwriters that might color the underwriter's judgment and cause it to recommend products, structures, and pricing levels to an issuer when it would not have done so absent such payments. For example, if a swap dealer affiliate of the underwriter were to make a payment to, or otherwise credit, the underwriter for the underwriter's successful recommendation that the issuer enter into a swap that is integrally related to a municipal securities issue, the Notice would require that such payment or credit be disclosed to the issuer. Generic disclosure would not suffice. However, only payments made in connection with the dealer's underwriting of a new issue would be required to be disclosed. Payments from purchasers of interests in tender option bond programs would not typically be made in connection with the underwriting and, therefore, would not typically be required to be disclosed. The MSRB considers it essential that an issuer be made aware of retail distribution and selling group arrangements that are integral to the underwriter's ability to provide the services that it has contracted with the issuer to provide. If such arrangements are already disclosed in official statements, this requirement of the Notice should not impose an additional burden on the underwriter.

- **Comments: Profit-Sharing with Investors.** SIFMA said that the MSRB should provide guidance on what is meant by profit-sharing with investors that, depending upon the facts and circumstances, could result in a Rule G-17 violation.

  **MSRB Response:** The provisions of the Notice concerning profit-sharing with investors resulted in part from reports to the MSRB that underwriters of Build America Bonds sold such bonds to institutional investors that then resold the bonds to such underwriters shortly thereafter at prices above their initial purchase price but below rising secondary market prices. If these reports were accurate and reflected formal or informal arrangements between such underwriters and institutional investors, these re-sales allowed the investors and the underwriters to share in the increase in value of the bonds. The MSRB has amended the Notice to note that "such arrangements could also constitute a violation of Rule G-25(c), which precludes a dealer from sharing, directly or indirectly, in the profits or losses of a transaction in municipal securities with or for a customer."

- **Comments: CDS Disclosures.** BDA said that general disclosures about trading in an issuer's CDS should suffice and that information barriers within firms might prevent more detailed knowledge by the dealer personnel underwriting an issuer's securities. SIFMA made the same arguments and additionally said that the proposal that underwriters disclose their CDS activity would be highly prejudicial because it would require underwriters to disclose their hedging and risk

management activities and could potentially compromise counterparty arrangements. It argued that, if this requirement were maintained by the MSRB, it should exempt dealing in CDS that reference a basket of securities, including the issuer's.

**MSRB Response:** The MSRB is mindful that appropriate information barriers may prevent personnel of a dealer firm engaged in underwriting activities from knowing about hedging activities of other parts of the dealer. However, the Notice requires only that a dealer that engages in the issuance or purchase of a credit default swap for which the underlying reference is an issuer for which the dealer is serving as underwriter, or an obligation of that issuer, must disclose that to the issuer. The Notice does not require information about specific trades or confidential counterparty information. The MSRB has amended the Notice to provide that disclosures would not be required with regard to trading in CDS based on baskets or indexes including the issuer or its obligation(s) unless the issuer or its obligation(s) represented more than 2% of the total notional amount of the credit default swap or the underwriter otherwise caused the issuer or its obligation(s) to be included in the basket or index. The most commonly traded municipal CDS basket -- Markit MCDX -- currently imposes this 2% limit on the components of its basket.

**Retail Order Periods**

- **Comments: Retail Orders.** BDA said that the MSRB should clarify what reasonable measures underwriters must take to ensure that retail orders are bona fide and said that underwriters should be able to rely on representations of selling group members. SIFMA made similar arguments about reliance upon representations of co-managers made in agreements among underwriters.

  **MSRB Response:** The MSRB is aware that, in many cases, orders are placed in retail order periods in a manner that is designed to "game" the retail order period requirements of the issuer. For example, in a retail order period in which the issuer has defined a retail order as one not exceeding $1,000,000 in principal amount, a dealer may place a number of $1,000,000 orders. Such a pattern of orders should cause a member of the underwriting syndicate to question whether such orders are bona fide retail orders. While it would be good practice for senior managing underwriters to require that co-managers and selling group members represent that orders represented to be retail orders in fact meet the issuer's definition of "retail," the MSRB would not consider such representations to be dispositive and would expect the senior manager to make appropriate inquiries when "red flags" such as described above could cause the senior manager to question the nature of the order. As an example of a "reasonable measure," a senior managing underwriter might require the zip codes attributable to the retail orders. With regard to orders placed by retail dealers, the MSRB reiterates that it

would not consider an order "for stock," without "going away orders," to be a customer order.[8]

**Dealer Payments to Issuer Personnel**

- **Comments: Rule G-20.** SIFMA requested that the MSRB clarify that its statements regarding Rule G-20 in the Notice were only reminders and that the MSRB did not intend to expand its previous guidance on Rule G-20 by means of the Notice.

  **MSRB Response:** The provisions in the Notice regarding Rule G-20 are only reminders of existing MSRB guidance.

**Miscellaneous**

- **Comments: Coordinated Rulemaking.** AFSCME strongly supported the notice; however, it urged the MSRB to coordinate its rulemaking with the SEC and the CFTC. BDA said that the Notice should not create overlapping and potentially conflicting obligations with SEC and CFTC rules and that the Notice might be premature, given ongoing rulemaking by the SEC and the CFTC. SIFMA said that the MSRB should defer the imposition of disclosure requirements concerning swaps and security-based swaps because these would be the subject of rulemaking by the SEC and CFTC.

  **MSRB Response:** The MSRB is aware of ongoing rulemaking by the SEC and the CFTC and has taken care to ensure that any requirements of the Notice are consistent with such rulemaking. For example, the provisions of the Notice concerning the disclosures associated with complex municipal securities financings are appropriately consistent with the CFTC's proposed business conduct rule for swap dealers and major swap participants[9] and the SEC's proposed business conduct rule for security-based swap dealers and major security-based swap participants.[10] The MSRB may undertake additional rulemaking as necessary to ensure such consistency in the future. In addition, dealers are reminded that they may be subject to other regulatory requirements.

- **Comments: Effective Date.** SIFMA argued that many of the Notice's requirements would require the development of compliance systems and that the Notice should not become effective for at least one year after its approval by the SEC.

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8 See Exchange Act Release No. 62715 (August 13, 2010) (File No. SR-MSRB-2009-17).

9 See Federal Register Vol. 75, No. 245 (December 22, 2010).

10 See Federal Register Vol. 76, No. 137 (July 18, 2011).

- **MSRB Response:** The MSRB agrees that some delay in the effective date of the proposed rule change is appropriate, because the MSRB has not previously articulated an interpretation of Rule G-17 that would require many of the specific disclosures required by the Notice. However, the MSRB considers a delay of one year to be too long. The MSRB has requested that the proposed rule change be made effective 90 days after approval by the Commission.

**6. Extension of Time Period of Commission Action**

The MSRB declines to consent to an extension of the time period specified in Section 19(b)(2) of the Exchange Act.

**7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2).**

Not applicable.

**8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

Not applicable.

**9. Exhibits**

1. Federal Register Notice

2. Notice Requesting Comment and Comment Letters

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(RELEASE NO. 34- ; File No. SR-MSRB-2011-09)

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing of Proposed Rule Change Consisting of Proposed Interpretive Notice Concerning the Application of MSRB Rule G-17, on Conduct of Municipal Securities and Municipal Advisory Activities, to Underwriters of Municipal Securities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("the Exchange Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on August 22, 2011, the Municipal Securities Rulemaking Board ("Board" or "MSRB") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the MSRB. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The MSRB is filing with the SEC a proposed rule change consisting of a proposed interpretive notice (the "Notice") concerning the application of MSRB Rule G-17 (on conduct of municipal securities and municipal advisory activities) to underwriters of municipal securities. The MSRB requests that the proposed rule change be made effective 90 days after approval by the Commission.

The text of the proposed rule change is available on the MSRB's website at www.msrb.org/Rules-and-Interpretations/SEC-Filings/2011-Filings.aspx, at the MSRB's principal office, and at the Commission's Public Reference Room.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the MSRB included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

(a) With the passage of the Dodd-Frank Act, the MSRB was expressly directed by Congress to protect municipal entities. Accordingly, the MSRB is proposing to provide additional interpretive guidance that addresses how Rule G-17 applies to dealers in the municipal securities activities described below.

A more-detailed description of the provisions of the Notice follows:

Representations to Issuers. The Notice would provide that all representations made by underwriters to issuers of municipal securities in connection with municipal securities underwritings (e.g., issue price certificates and responses to requests for proposals), whether written or oral, must be truthful and accurate and may not misrepresent or omit material facts.

Required Disclosures to Issuers. The Notice would provide that an underwriter of a negotiated issue that recommends a complex municipal securities transaction or product (e.g., a variable rate demand obligation with a swap) to an issuer has an obligation under Rule G-17 to disclose all material risks (e.g., in the case of a swap, market, credit, operational, and liquidity risks), characteristics, incentives, and conflicts of interest (e.g., payments received from a swap

provider) regarding the transaction or product. Such disclosure would be required to be sufficient to allow the issuer to assess the magnitude of its potential exposure as a result of the complex municipal securities financing. In the case of routine financing structures, underwriters would be required to disclose the material aspects of the structures if the issuers did not otherwise have knowledge or experience with respect to such structures.

The disclosures would be required to be made in writing to an official of the issuer whom the underwriter reasonably believed had the authority to bind the issuer by contract with the underwriter (i) in sufficient time before the execution of a contract with the underwriter to allow the official to evaluate the recommendation and (ii) in a manner designed to make clear to such official the subject matter of such disclosures and their implications for the issuer. If the underwriter did not reasonably believe that the official to whom the disclosures were addressed was capable of independently evaluating the disclosures, the underwriter would be required to make additional efforts reasonably designed to inform the official or its employees or agent.[3]

Underwriter Duties in Connection with Issuer Disclosure Documents. The Notice would provide that a dealer's duty to have a reasonable basis for the representations it makes, and other material information it provides, to an issuer and to ensure that such representations and information are accurate and not misleading, as described above, extends to representations and information provided by the underwriter in connection with the preparation by the issuer of its disclosure documents (e.g., cash flows).

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[3] Section 4s(h)(5) of the Commodity Exchange Act requires that a swap dealer with a special entity client (including states, local governments, and public pension funds) must have a reasonable basis to believe that the special entity has an independent representative that has sufficient knowledge to evaluate the transaction and its risks, as well as the pricing and appropriateness of the transaction. Section 15F(h)(5) of the Exchange Act imposes the same requirements with respect to security-based swaps.

New Issue Pricing and Underwriter Compensation. The Notice would provide that the duty of fair dealing under Rule G-17 includes an implied representation that the price an underwriter pays to an issuer is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value of the issue at the time it is priced. The Notice distinguishes the fair pricing duties of competitive underwriters (submission of bona fide bid based on dealer's best judgment of fair market value of securities) and negotiated underwriters (duty to negotiate in good faith). The Notice would provide that, in certain cases and depending upon the specific facts and circumstances of the offering, the underwriter's compensation for the new issue (including both direct compensation paid by the issuer and other separate payments or credits received by the underwriter from the issuer or any other party in connection with the underwriting) may be so disproportionate to the nature of the underwriting and related services performed, as to constitute an unfair practice that is a violation of Rule G-17.

Conflicts of Interest. The Notice would require disclosure by an underwriter of potential conflicts of interest, including third-party payments, values, or credits made or received, profit-sharing arrangements with investors, and the issuance or purchase of credit default swaps for which the underlying reference is the issuer whose securities the dealer is underwriting or an obligation of that issuer.

Retail Order Periods. The Notice would remind underwriters not to disregard the issuers' rules for retail order periods by, among other things, accepting or placing orders that do not satisfy issuers' definitions of "retail."

Dealer Payments to Issuers. Finally, the Notice would remind underwriters that certain lavish gifts and entertainment, such as those made in conjunction with rating agency trips, might be a violation of Rule G-17, as well as Rule G-20.

(b) The MSRB believes that the proposed rule change is consistent with Section 15B(b)(2) of the Exchange Act, which provides that:

> The Board shall propose and adopt rules to effect the purposes of this title with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers and advice provided to or on behalf of municipal entities or obligated persons by brokers, dealers, municipal securities dealers, and municipal advisors with respect to municipal financial products, the issuance of municipal securities, and solicitations of municipal entities or obligated persons undertaken by brokers, dealers, municipal securities dealers, and municipal advisors.

Section 15B(b)(2)(C) of the Exchange Act, provides that the rules of the MSRB shall:

> be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities and municipal financial products, to remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in general, to protect investors, municipal entities, obligated persons, and the public interest.

The proposed rule change is consistent with Section 15B(b)(2) of the Exchange Act because it will protect issuers of municipal securities from fraudulent and manipulative acts and practices and promote just and equitable principles of trade, while still emphasizing the duty of fair dealing owed by underwriters to their customers. Rule G-17 has two components, one an anti-fraud prohibition, and the other a fair dealing requirement (which promotes just and equitable principles of trade). The Notice would address both components of the rule. The sections of the Notice entitled “Representations to Issuers,” “Underwriter Duties in Connection with Issuer Disclosure Documents,” “Excessive Compensation,” “Payments to or from Third Parties,” “Profit-Sharing with Investors,” “Retail Order Periods,” and “Dealer Payments to Issuer

Personnel" primarily would provide guidance as to conduct required to comply with the anti-fraud component of the rule and, in some cases, conduct that would violate the anti-fraud component of the rule, depending on the facts and circumstances. The sections of the Notice entitled "Required Disclosures to Issuers," "Fair Pricing," and "Credit Default Swaps" primarily would provide guidance as to conduct required to comply with the fair dealing component of the rule.

B. Self-Regulatory Organization's Statement on Burden on Competition

The MSRB does not believe that the proposed rule change would impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, since it would apply equally to all underwriters of municipal securities.

C. Self-Regulatory Organization's Statement on Comments Received on the Proposed Rule Change Received from Members, Participants, or Others

On February 14, 2011, the MSRB requested comment on the proposed rule change.[4] The MSRB received 5 comment letters. Comment letters were received from the American Federation of State, County and Municipal Employees ("AFSCME"); the Bond Dealers of America ("BDA"); Municipal Regulatory Consulting LLC ("MRC"); the National Association of Independent Public Finance Advisors ("NAIPFA"); and the Securities Industry and Financial Markets Association ("SIFMA"). The comments are summarized according to the subject headings of the Notice.

Representations to Issuers

- Comments: Reasonable Basis for Certificates. SIFMA said that the MSRB should reconsider the requirement for an underwriter to have a reasonable basis for the representations and material information in certificates it provides, arguing that other

[4] See MSRB Notice 2011-12 (February 14, 2011).

regulatory requirements (e.g., IRC Section 6700 and wire fraud statutes) already govern such representations. It said that the MSRB should, at least, confirm that an underwriter would meet this obligation when it verifies the information in the certificate against the official books of the issuer and any other factual information within the underwriter's control.

MSRB Response: The MSRB has determined to make no change to this requirement of the Notice and notes that the "reasonable basis" requirement of the Notice in the context of certificates provided by an underwriter is consistent with the view of the Commission that the underwriter must have a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in an offering of municipal securities. See endnote 10 to the Notice. It is also consistent with Internal Revenue Service interpretations of Section 6700 of the Internal Revenue Code, which address the application of the penalty to statements (including underwriter certificates) material to tax exemption that the maker knew or had "reason to know" were false or fraudulent, such as the one cited in note 9 to SIFMA's comment letter. Therefore, the Notice imposes no additional requirement upon underwriters.

Review of the official books of the issuer and other factual information within the underwriter's control may assist the underwriter in forming a reasonable basis for its certificate. However, if the certificate relies on the representations of others or facts not within the underwriter's control, additional due diligence on the part of the underwriter may be required. The MSRB notes that a quote from the Internal Revenue Service publication cited in SIFMA's letter provides some useful guidance on the level of inquiry required: "Participants [in a bond financing] can rely on matters of fact or material

provided by other participants necessary to make their own statements or draw their own conclusions, unless they have actual knowledge or a reason to know of its inaccuracy or the statement is not credible or reasonable on its face." The Internal Revenue Service summarized the legislative history of Section 6700. See H. Conf. Rep. No. 101-247, 101st Cong., 1st Sess. 1397.

Required Disclosures to Issuers

- Comments: Complex Financings. SIFMA argued that more guidance is needed on the complex municipal securities financings requirements.
    - It said that a transaction should only be deemed complex if the municipal issuer informed the underwriter that the issuer had never engaged in the type of transaction before and therefore might not understand the transaction's material risks and characteristics.
    - It also said that the MSRB should provide more guidance and definition with regard to what types of transactions will be considered "complex," arguing that references to "external index not typically used in the municipal securities market" and "atypical or complex arrangements" were vague.
    - It also said that issuers that required an analysis of the risks and characteristics of a transaction should hire independent advisors or separately contract for this service with their underwriters.

MSRB Response: In response to SIFMA's first comment above, the MSRB has added the following language to the Notice: "The level of disclosure required may vary according to the issuer's knowledge or experience with the proposed financing structure or similar structures, capability of evaluating the risks of the recommended financing, and

financial ability to bear the risks of the recommended financing, in each case based on the reasonable belief of the underwriter." This language is based on the suitability analysis required by the Financial Industry Regulatory Authority ("FINRA") of dealers selling complex products, such as options and securities futures,[5] although the Notice does not go so far as to impose a suitability requirement on underwriters of municipal securities with respect to issuers.[6] The MSRB notes that this language applies only to disclosures concerning material terms and characteristics of a complex municipal securities financing. The Notice also provides: "In all events, the underwriter must disclose any incentives for the underwriter to recommend the complex municipal securities financing and other associated conflicts of interest." The MSRB does not agree with SIFMA that an issuer should be required to exercise its supposed "bargaining power" in order to receive such disclosures.

In response to SIFMA's second comment above, the Notice does provide examples of complex municipal securities financings: "variable rate demand obligations ("VRDOs") and financings involving derivatives (such as swaps)." In response to SIFMA's comment, the Notice now also distinguishes those examples from: "the typical fixed rate offering." It also now provides that: "Even a financing in which the interest rate is benchmarked to an index that is commonly used in the municipal marketplace (e.g.,

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5 FINRA Rules 2360 and 2370.

6 The Notice does not address whether engaging in any of the activities described in the Notice would cause a dealer to be considered a "municipal advisor" under the Exchange Act and the rules promulgated thereunder and, therefore, subject to a fiduciary duty. The MSRB notes that dealers that recommend swaps or security-based swaps to municipal entities may also be subject to rules of the Commodity Futures Trading Commission or those of the SEC. See, e.g., Federal Register Vol. 75, No. 245 (December 22, 2010) and Federal Register Vol. 76, No. 137 (July 18, 2011).

LIBOR or SIFMA) may be complex to an issuer that does not understand the components of that index or its possible interaction with other indexes."

With regard to SIFMA's third comment, while the MSRB agrees that an issuer seeking an independent assessment of the risks and characteristics of a transaction recommended by an underwriter may wish to hire a separate municipal advisor for that purpose, at its own election, the MSRB is firmly of the view that basic principles of fair dealing require an underwriter to disclose the risks and characteristics of a complex municipal securities financing that it has itself determined to recommend to the issuer.

The MSRB notes that the Notice has been amended to provide that, in the case of routine financing structures, underwriters would be required to disclose the material aspects of the structures if the issuers did not otherwise have knowledge or experience with respect to such structures.

- Comments: Recommendations. NAIPFA argued that underwriters should also be required -- in the same manner and to the same extent as advisors would be required -- to have a reasonable basis for any recommendation they made and to disclose material risks about the course of conduct they recommend, along with the risks and potential benefits of reasonable alternatives then available in the market. SIFMA said that the MSRB should clarify whether a dealer's recommendation of a swap will subject it to a fiduciary duty. MRC said that the requirements for disclosures in the context of complex municipal securities financings should be set forth in Rule G-19.

  MSRB Response: The MSRB has determined not to impose a suitability duty in this context at this time. The Notice also does not address whether the provision of advice by underwriters will cause them to be considered municipal advisors under the Exchange

Act and, accordingly, subject to a fiduciary duty. In the view of the MSRB, the duty of fair dealing is subsumed within a fiduciary duty, so additional duties may apply to the provision of advice by underwriters that the Commission considers to be municipal advisory activities. See also footnote 6 herein.

- Comments: Recipients of Disclosures. BDA and SIFMA said that an underwriter should only need to have a reasonable belief that it was making required disclosures to officials with the authority to bind the issuer, particularly if the official represented that he/she has such authority.

  MSRB Response: The MSRB agrees with this comment and has revised the Notice accordingly.

- Comments: Timing of Disclosures. SIFMA said that the MSRB should clarify that disclosures should only be required once. It said that, as an example, a representation in a response to an RFP or otherwise before the underwriter is engaged should suffice.

  MSRB Response: The Notice does not require disclosures to be made more than once per issue. An RFP response could be an appropriate place to make required disclosures as long as the proposed structure of the financing is adequately developed at that point to permit the disclosures required by the Notice.

Underwriter Duties in Connection with Issuer Disclosure Documents

- Comments: Reasonable Basis for Official Statement Materials. SIFMA argued that an underwriter should not be required to have a reasonable basis for the representations it makes, or other material information it provides in connection with the preparation by the issuer of its disclosure documents. Instead, SIFMA argued that the MSRB should permit an underwriter to agree with an issuer that the underwriter will only be responsible for

materials furnished to an issuer if the underwriter has (i) consented, in writing, to such materials being used in offering documents and (ii) agreed with the issuer that the underwriter and not the issuer will assume responsibility for the accuracy and proper presentation of such material. SIFMA said that an underwriter should be able to limit its responsibility for information provided by disclosing to the issuer any limitations on the scope of its analysis and factual verification it performed. Furthermore, it argued that any duty should extend only to material information provided by the underwriter and not to all information and analysis, suggesting that an underwriter should not have to verify the assumptions and facts that underlie cash flows it prepared.

MSRB Response: The MSRB does not agree with this comment and reminds SIFMA of the view of the SEC as summarized in endnote 9 to the Notice: With respect to primary offerings of municipal securities, the SEC has noted, "By participating in an offering, an underwriter makes an implied recommendation about the securities." See SEC Rel. No. 34-26100 (Sept. 22, 1988) (proposing Exchange Act Rule 15c2-12) at text following note 70 (the "1988 Proposing Release"). The SEC stated in the 1988 Proposing Release that "this recommendation itself implies that the underwriter has a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings." It would seem a curious result, therefore, for the underwriter not to be required under Rule G-17 to have a reasonable basis for its own representations set forth in the official statement, as well as a reasonable basis for the material information it provides to the issuer in connection with the preparation of the official statement, including a reasonable belief in the truthfulness and completeness of

any information provided by others that serves as a material basis for such underwriter's information.

Underwriter Compensation and New Issue Pricing

- Comments: Fair Pricing. BDA said that the fair pricing obligation in the context of a new issue should employ a good faith standard. It said that there is no prevailing market price for new issues and that comparisons to secondary market trades are difficult because of the infrequency of trades and the differences among issuers. Similarly, SIFMA said that an underwriter should only be required to purchase securities at the price that it and the issuer negotiated and agreed to in good faith, without regard to a prevailing market price, which it said does not exist for new issue securities. It said that the MSRB's proposal will encourage increased reliance on credit ratings, which it characterized as contrary to the intent of Dodd-Frank and SEC policy guidance.

  MSRB Response: In response to this comment, the MSRB has amended the Notice to remove references to prevailing market price. Consistent with SIFMA's observation that many underwriters already make representations as to the fair market price of new issues in tax certificates to issuers, the Notice now reads: "The duty of fair dealing under Rule G-17 includes an implied representation that the price an underwriter pays to an issuer is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value of the issue at the time it is priced."

Conflicts of Interest

- Comments: Conflicts Disclosure. NAIPFA argued that underwriters should be required to comply with all the rules regarding conflicts to which municipal advisors would be subject under Rule G-17. Specifically, NAIPFA said that underwriters should be required to disclose with respect to all issues that they:
    - are not acting as advisors but as underwriters;
    - are not fiduciaries to the issuer but rather counterparties dealing at arm's-length;
    - have conflicts with issuers because they represent the interests of the investors or other counterparties, which may result in benefits to other transaction participants at direct cost to the issuer;
    - seek to maximize their profitability and such profitability may or may not be transparent or disclosed to the issuer; and
    - have no continuing obligation to the issuer following the closing of transactions.

  On the other hand, SIFMA argued that the Notice would impose a "fiduciary-lite" duty on underwriters, citing as examples the disclosures required of underwriters recommending complex municipal securities financings and the required disclosures of business relationships and methods of doing business, including their financial incentives. It said that underwriters should not be required to make such disclosures as long as their failure to do so did not amount to false or fraudulent conduct.

  MSRB Response: A number of NAIPFA's suggested disclosures were presented to the MSRB in connection with the MSRB's proposed amendments to Rule G-23 and were addressed by the MSRB in its filing with the SEC.[7] The MSRB's interpretive notice regarding Rule G-23 contained in that filing provides that a dealer will be considered to

[7] See Amendment No. 1 to SR-MSRB-2011-03 (May 26, 2011). See also Exchange Act Release No. 64564 (May 27, 2011) (File No. SR-MSRB-2011-03).

be acting as an underwriter for purposes of Rule G-23(b) if, among other things, it provides written disclosure to the issuer from the earliest stages of its relationship with the issuer that it is an underwriter and not a financial advisor and does not engage in a course of conduct that is inconsistent with arm's-length relationship with the issuer. The writing must make clear that the primary role of an underwriter is to purchase, or arrange for the placement of, securities in an arm's-length commercial transaction between the issuer and the underwriter and that the underwriter has financial and other interests that differ from those of the issuer. Rule G-17 is appropriately applied differently to market participants with different roles in a financing. Thus, for example, Rule G-17 may appropriately be interpreted to apply different standards of conduct to municipal advisors, which function as trusted advisors to municipal entities and obligated persons, than it does to underwriters of municipal securities, which are arm's-length counterparties to issuers of municipal securities, and dealers who solicit municipal entities on behalf of third-party clients.

Consistent with this interpretation of Rule G-17, the disclosures required by the Notice do not amount to the imposition of a fiduciary duty, whether "lite" or otherwise, on underwriters of municipal securities. Simple principles of fair dealing require that underwriters have more than a caveat emptor relationship with their issuer clients.

- Comments: Payments to and from Third Parties. BDA said that the MSRB should clarify what types of third party payments it was interested in and that they should not include tender option bond programs and similar arrangements. Alternatively, BDA said that generic disclosure should suffice. It argued that a requirement to disclose retail distribution and selling group arrangements was unnecessary because such arrangements

were typically disclosed in official statements. In addition, SIFMA said that the MSRB should clarify the details of required disclosures and confirm that issuer consent to disclosures regarding third-party payments is not required. It argued that payments or internal credits among the underwriter and its affiliates should not be required to be disclosed. It made the same argument with respect to payments or other benefits received from collateral transactions, such as credit default swaps (CDS). While it argued that the proposed standard was inconsistent with SEC and FINRA requirements, it did not cite specific examples.

MSRB Response: The MSRB believes that issuers of municipal securities should be apprised of payments, values, or credits made to underwriters that might color the underwriter's judgment and cause it to recommend products, structures, and pricing levels to an issuer when it would not have done so absent such payments. For example, if a swap dealer affiliate of the underwriter were to make a payment to, or otherwise credit, the underwriter for the underwriter's successful recommendation that the issuer enter into a swap that is integrally related to a municipal securities issue, the Notice would require that such payment or credit be disclosed to the issuer. Generic disclosure would not suffice. However, only payments made in connection with the dealer's underwriting of a new issue would be required to be disclosed. Payments from purchasers of interests in tender option bond programs would not typically be made in connection with the underwriting and, therefore, would not typically be required to be disclosed. The MSRB considers it essential that an issuer be made aware of retail distribution and selling group arrangements that are integral to the underwriter's ability to provide the services that it has contracted with the issuer to provide. If such arrangements are already disclosed in

official statements, this requirement of the Notice should not impose an additional burden on the underwriter.

- Comments: Profit-Sharing with Investors. SIFMA said that the MSRB should provide guidance on what is meant by profit-sharing with investors that, depending upon the facts and circumstances, could result in a Rule G-17 violation.

  MSRB Response: The provisions of the Notice concerning profit-sharing with investors resulted in part from reports to the MSRB that underwriters of Build America Bonds sold such bonds to institutional investors that then resold the bonds to such underwriters shortly thereafter at prices above their initial purchase price but below rising secondary market prices. If these reports were accurate and reflected formal or informal arrangements between such underwriters and institutional investors, these re-sales allowed the investors and the underwriters to share in the increase in value of the bonds. The MSRB has amended the Notice to note that "such arrangements could also constitute a violation of Rule G-25(c), which precludes a dealer from sharing, directly or indirectly, in the profits or losses of a transaction in municipal securities with or for a customer."

- Comments: CDS Disclosures. BDA said that general disclosures about trading in an issuer's CDS should suffice and that information barriers within firms might prevent more detailed knowledge by the dealer personnel underwriting an issuer's securities. SIFMA made the same arguments and additionally said that the proposal that underwriters disclose their CDS activity would be highly prejudicial because it would require underwriters to disclose their hedging and risk management activities and could potentially compromise counterparty arrangements. It argued that, if this requirement

were maintained by the MSRB, it should exempt dealing in CDS that reference a basket of securities, including the issuer's.

MSRB Response: The MSRB is mindful that appropriate information barriers may prevent personnel of a dealer firm engaged in underwriting activities from knowing about hedging activities of other parts of the dealer. However, the Notice requires only that a dealer that engages in the issuance or purchase of a credit default swap for which the underlying reference is an issuer for which the dealer is serving as underwriter, or an obligation of that issuer, must disclose that to the issuer. The Notice does not require information about specific trades or confidential counterparty information. The MSRB has amended the Notice to provide that disclosures would not be required with regard to trading in CDS based on baskets or indexes including the issuer or its obligation(s) unless the issuer or its obligation(s) represented more than 2% of the total notional amount of the credit default swap or the underwriter otherwise caused the issuer or its obligation(s) to be included in the basket or index. The most commonly traded municipal CDS basket -- Markit MCDX -- currently imposes this 2% limit on the components of its basket.

Retail Order Periods

- Comments: Retail Orders. BDA said that the MSRB should clarify what reasonable measures underwriters must take to ensure that retail orders are bona fide and said that underwriters should be able to rely on representations of selling group members. SIFMA made similar arguments about reliance upon representations of co-managers made in agreements among underwriters.

  MSRB Response: The MSRB is aware that, in many cases, orders are placed in retail order periods in a manner that is designed to "game" the retail order period requirements

of the issuer. For example, in a retail order period in which the issuer has defined a retail order as one not exceeding $1,000,000 in principal amount, a dealer may place a number of $1,000,000 orders. Such a pattern of orders should cause a member of the underwriting syndicate to question whether such orders are bona fide retail orders. While it would be good practice for senior managing underwriters to require that co-managers and selling group members represent that orders represented to be retail orders in fact meet the issuer's definition of "retail," the MSRB would not consider such representations to be dispositive and would expect the senior manager to make appropriate inquiries when "red flags" such as described above could cause the senior manager to question the nature of the order. As an example of a "reasonable measure," a senior managing underwriter might require the zip codes attributable to the retail orders. With regard to orders placed by retail dealers, the MSRB reiterates that it would not consider an order "for stock," without "going away orders," to be a customer order.[8]

Dealer Payments to Issuer Personnel

- Comments: Rule G-20. SIFMA requested that the MSRB clarify that its statements regarding Rule G-20 in the Notice were only reminders and that the MSRB did not intend to expand its previous guidance on Rule G-20 by means of the Notice.

  MSRB Response: The provisions in the Notice regarding Rule G-20 are only reminders of existing MSRB guidance.

Miscellaneous

- Comments: Coordinated Rulemaking. AFSCME strongly supported the notice; however, it urged the MSRB to coordinate its rulemaking with the SEC and the CFTC. BDA said

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[8] See Exchange Act Release No. 62715 (August 13, 2010) (File No. SR-MSRB-2009-17).

that the Notice should not create overlapping and potentially conflicting obligations with SEC and CFTC rules and that the Notice might be premature, given ongoing rulemaking by the SEC and the CFTC. SIFMA said that the MSRB should defer the imposition of disclosure requirements concerning swaps and security-based swaps because these would be the subject of rulemaking by the SEC and CFTC.

MSRB Response: The MSRB is aware of ongoing rulemaking by the SEC and the CFTC and has taken care to ensure that any requirements of the Notice are consistent with such rulemaking. For example, the provisions of the Notice concerning the disclosures associated with complex municipal securities financings are appropriately consistent with the CFTC's proposed business conduct rule for swap dealers and major swap participants[9] and the SEC's proposed business conduct rule for security-based swap dealers and major security-based swap participants.[10] The MSRB may undertake additional rulemaking as necessary to ensure such consistency in the future. In addition, dealers are reminded that they may be subject to other regulatory requirements.

- Comments: Effective Date. SIFMA argued that many of the Notice's requirements would require the development of compliance systems and that the Notice should not become effective for at least one year after its approval by the SEC.

  MSRB Response: The MSRB agrees that some delay in the effective date of the proposed rule change is appropriate, because the MSRB has not previously articulated an interpretation of Rule G-17 that would require many of the specific disclosures required by the Notice. However, the MSRB considers a delay of one year to be too long. The

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9 See Federal Register Vol. 75, No. 245 (December 22, 2010).

10 See Federal Register Vol. 76, No. 137 (July 18, 2011).

MSRB has requested that the proposed rule change be made effective 90 days after approval by the Commission.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Exchange Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-MSRB-2011-09 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-MSRB-2011-09. This file number should be

included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the MSRB's offices. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-MSRB-2011-09 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[11]

Elizabeth M. Murphy
Secretary

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[11] 17 CFR 200.30-3(a)(12).

MSRB
Municipal Securities
Rulemaking Board

# MSRB NOTICE 2011-12 (FEBRUARY 14, 2011)

# REQUEST FOR COMMENT ON DRAFT INTERPRETIVE NOTICE CONCERNING THE APPLICATION OF MSRB RULE G-17 TO UNDERWRITERS OF MUNICIPAL SECURITIES

The Municipal Securities Rulemaking Board ("MSRB") is requesting comment on a draft interpretive notice concerning the application of MSRB Rule G-17 to underwriters of municipal securities.

Comments should be submitted no later than April 11, 2011. Comments should be sent via e-mail to CommentLetters@msrb.org. Please indicate the notice number in the subject line of the e-mail. To submit comments via regular mail, please send them to Ronald W. Smith, Corporate Secretary, MSRB, 1900 Duke Street, Alexandria, VA 22314. Written comments will be available for public inspection on the MSRB's web site.[1]

Questions about this notice should be directed to Peg Henry, Deputy General Counsel, or Larry Sandor, Senior Associate General Counsel, at 703-797-6600.

**BACKGROUND**

The MSRB has previously observed that Rule G-17 requires dealers to deal fairly with issuers in connection with the underwriting of their municipal securities.[2] More recently, in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. Law No. 111-203) ("Dodd-Frank Act"), Congress amended Section 15B of the Securities Exchange Act of 1934 ("Exchange Act") to provide express direction to the MSRB to protect municipal entities.[3]

**REQUEST FOR COMMENT**

The MSRB requests comments on the interpretive guidance set forth below, which addresses how Rule G-17 applies to dealers in their interactions with municipal entities as underwriters of municipal securities, including integrally-related activities, such as interest rate swap transactions and purchases of defeasance escrow securities.

Rule G-17 provides:

> In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

Under Rule G-17, all representations made by underwriters to issuers of municipal securities in connection with municipal securities underwritings, whether written or oral, must be truthful and accurate and may not misrepresent or omit material facts. Furthermore, an underwriter of a negotiated issue that recommends a complex municipal securities financing (*e.g.*, a variable rate demand obligation with a swap) has an obligation under Rule G-17 to disclose all material risks and characteristics of the financing, as well as any incentives for the underwriter to recommend the financing and other associated conflicts of interest.

The duty of fair dealing under Rule G-17 includes an implied representation that the price an underwriter pays to an issuer bears a reasonable relationship to the prevailing market price of the securities. An underwriter's direct and indirect compensation for a new issue must not be excessive (*i.e.*, disproportionate to the nature of the underwriting and related services performed).

Under Rule G-17, an underwriter must disclose conflicts of interest (*e.g.*, third-party payments, certain credit default swaps, and profit-sharing arrangements with investors) that may color its judgment and cause it to recommend products, structures, and pricing levels to an issuer that it would not have done absent such conflicts.

The notice also restates existing MSRB guidance under Rule G-17, which provides that an underwriter must honor an issuer's directions concerning retail order periods and must not make lavish gifts to issuer personnel.[4]

**TEXT OF DRAFT INTERPRETIVE NOTICE**

**INTERPRETIVE GUIDANCE CONCERNING THE APPLICATION OF MSRB RULE G-17 TO UNDERWRITERS OF MUNICIPAL SECURITIES**

Under Rule G-17 of the Municipal Securities Rulemaking Board (the "MSRB"), brokers, dealers, and municipal securities dealers ("dealers") must, in the conduct of their municipal securities activities, deal fairly with all persons and must not engage in any deceptive, dishonest, or unfair practice. This rule is most often cited in connection with duties owed by dealers to investors; however, it also applies to their interactions with other market participants, including municipal entities.[1]

The MSRB has previously observed that Rule G-17 requires dealers to deal fairly with issuers in connection with the underwriting of their municipal securities.[2] More recently, with the passage of the Dodd-Frank Act,[3] the MSRB was expressly directed by Congress to protect municipal entities. Accordingly, the MSRB is providing additional interpretive guidance that addresses how Rule G-17 applies to dealers in their interactions with municipal entities as underwriters of municipal securities, including integrally-related activities, such as interest rate swap transactions and purchases of defeasance escrow securities.

The examples discussed in this notice are illustrative only and are not meant to encompass all obligations of dealers to municipal entities under Rule G-17. The MSRB has issued other interpretive guidance on a dealer's duties under Rule G-17 when the dealer is serving as an advisor to a municipal entity or obligated person.[4] Furthermore, when municipal entities are customers[5] of dealers they are subject to the same protections under MSRB rules, including Rule G-17, that apply to other customers.[6] Additionally, the MSRB notes that an underwriter must balance its duty of fair dealing to issuers with its duty of fair dealing to investors, as well as its duty to comply with other federal and state securities laws.

**Basic Fair Dealing Principle**

As noted above, Rule G-17 precludes a dealer, in the conduct of its municipal securities activities, from engaging in any deceptive, dishonest, or unfair practice with any person, including an issuer of municipal securities. The rule contains an anti-fraud prohibition similar to the standard set forth in Rule 10b-5 adopted by the Securities and Exchange Commission ("SEC") under the Exchange Act. Thus, an underwriter must not misrepresent the facts, risks, or other material information about municipal securities activities undertaken with a municipal issuer. However, Rule G-17 does not merely prohibit deceptive conduct on the part of the dealer.

It also establishes a general duty of a dealer to deal fairly with all persons (including but not limited to issuers of municipal securities), even in the absence of fraud.

**Representations to Issuers**

All representations made by underwriters to issuers of municipal securities in connection with municipal securities underwritings, whether written or oral, must be truthful and accurate and may not misrepresent or omit material facts. Underwriters must have a reasonable basis for the representations and other material information contained in documents they prepare and should refrain from including representations or other information they know or should know is inaccurate or misleading. For example, in connection with a certificate signed by the underwriter that will be relied upon by the issuer or other relevant parties to an underwriting (*e.g.*, an issue price certificate), the dealer must have a reasonable basis for the representations and other material information contained therein. In addition, a dealer's response to an issuer's request for proposals must fairly and accurately describe the services, skills, background, and experience of the dealer as of the time the proposal is submitted and must not contain any representations or other material information about such services, skills, background and experience that the dealer knows or should know is inaccurate or misleading. For example, a dealer must not make representations about its underwriting capabilities that are inaccurate, and matters not within the personal knowledge of those preparing the response (*e.g.*, pending litigation) must be confirmed with those with knowledge of the subject matter.

**Required Disclosures to Issuer**

An underwriter of a negotiated issue that recommends a municipal securities financing to an issuer that involves a derivative contract (such as a swap), an external index not typically used in the municipal securities market, issuer cash flows that are unusual or variable, or other atypical or complex arrangements that are integrally related (both in time and economics) to the financing (a "complex municipal securities financing") has an obligation under Rule G-17 to disclose all material risks and characteristics of the complex municipal securities financing, as well as any incentives for the underwriter to recommend the financing and other associated conflicts of interest. For example, an underwriter that recommends a complex municipal securities financing involving variable issuer payments should inform the issuer of the risk of interest rate fluctuations and material risks of any associated credit or liquidity facilities (*e.g.*, the risk that the issuer might not be able to replace the facility upon its expiration and might be required to repay the facility provider over a short period of time). As a additional example, if the recommended complex municipal securities financing involves an integrally-related swap, the underwriter must disclose the material risks (including market, credit, operational, and liquidity risks) and characteristics of the integrally-related swap, as well as any incentives for the underwriter to recommend the swap and any other associated conflicts of interest.[7] In general, if the underwriter is not the provider of the swap or other component of a complex municipal securities financing, it may satisfy its disclosure obligation if it reasonably believes that such disclosure has been provided to the issuer by the swap or other provider or by the issuer's swap or other financial advisor that is independent of the underwriter and the swap or other provider.

The disclosures described in this notice must be made in writing to officials of the issuer with the authority to bind the issuer by contract with the underwriter in a manner designed to make clear to such officials the subject matter of such disclosures and their implications for the issuer. The disclosures must be provided prior to the execution of the complex municipal securities financing and must address the specific elements of the financing, rather than being general in nature.

**Underwriter Duties in Connection with Issuer Disclosure Documents**

Underwriters often play an important role in assisting issuers in the preparation of disclosure documents, such as preliminary official statements and official statements.[8] These documents are critical to the municipal securities transaction, in that investors rely on the representations contained in such documents in making their investment decisions. Moreover, investment professionals, such as municipal securities analysts and ratings services, rely on the representations in forming an opinion regarding the credit. A dealer's duty to have a reasonable basis for the representations it makes, and other material information it provides, to an issuer and to ensure that such representations and information are accurate and not misleading, as described above, extends to representations and information provided by the underwriter in connection with the preparation by the issuer of its disclosure documents (*e.g.*, cash flows).

**Underwriter Compensation and New Issue Pricing**

**Excessive Compensation**. An underwriter's compensation for a new issue (including both direct compensation paid by the issuer and other separate payments received by the underwriter from the issuer or any other party in connection with the underwriting), in certain cases and depending upon the specific facts and circumstances of the offering, may be so disproportionate to the nature of the underwriting and related services performed as to constitute an unfair practice with regard to the issuer that is a violation of Rule G-17. Among the factors relevant to whether an underwriter's compensation is disproportionate to the nature of the underwriting and related services performed, are the credit quality of the issue, the size of the issue, market conditions, the length of time spent structuring the issue, and whether the underwriter is paying the fee of the underwriter's counsel or any other relevant costs related to the financing.

**Fair Pricing**. The duty of fair dealing under Rule G-17 includes an implied representation that the price an underwriter pays to an issuer bears a reasonable relationship to the prevailing market price of the securities.[9] In general, a dealer purchasing bonds in a competitive underwriting for which the issuer may reject any and all bids will be deemed to have satisfied its duty of fairness to the issuer with respect to the purchase price of the issue as long as the dealer's bid is a *bona fide* bid (as defined in MSRB Rule G-13)[10] that is based on the dealer's best judgment of the fair market value of the securities that are the subject of the bid. In a negotiated underwriting, the underwriter has a duty under Rule G-17 to negotiate in good faith with the issuer. This duty includes the obligation of the dealer to ensure the accuracy of representations made during the course of such negotiations, including representations regarding the price negotiated and the nature of investor demand for the securities (*e.g.*, the status of the order period and the order book). If, for example, the dealer represents to the issuer that it is providing the "best" market price available on the new issue, or that it will exert its best efforts to obtain the "most favorable" pricing, the dealer may violate Rule G-17 if its actions are inconsistent with such representations.[11]

**Conflicts of Interest**

**Payments to or from Third Parties**. In certain cases, compensation received by the underwriter from third parties, such as the providers of derivatives and investments, may color the underwriter's judgment and cause it to recommend products, structures, and pricing levels to an issuer when it would not have done so absent such payments. The MSRB views the failure of an underwriter to disclose to the issuer payments received by the underwriter in connection with its underwriting of the new issue from parties other than the issuer, and payments made by the underwriter in connection with such new issue to parties other than the issuer (in either case including payments with respect to collateral transactions integrally related to such underwriting), to be a violation of the underwriter's obligation to the issuer under Rule G-17. Such disclosure obligation also would apply to payments in respect to collateral transactions integrally related to

such underwriting, including but not limited to municipal securities derivative transactions and defeasance escrow securities transactions that are integrally related to the underwriting.[12] For example, it would be a violation of Rule G-17 for an underwriter to compensate an undisclosed party in order to secure municipal securities business. Similarly, it would be a violation of Rule G -17 for an underwriter to receive undisclosed compensation from a third party in exchange for recommending that third party's services or product to an issuer, including business related to municipal securities derivative transactions. The underwriter must disclose to the issuer the amount paid or received, the purpose for which such payment was made and the name of the party making or receiving such payment. The underwriter must also disclose to the issuer the details of any third-party arrangements for the marketing of the issuer's securities.

**Profit-Sharing with Investors**. Arrangements between the underwriter and an investor purchasing new issue securities from the underwriter (including purchases that are contingent upon the delivery by the issuer to the underwriter of the securities) according to which profits realized from the resale by such investor of the securities are directly or indirectly split or otherwise shared with the underwriter also would, depending on the facts and circumstances (including in particular if such resale occurs reasonably close in time to the original sale by the underwriter to the investor), constitute a violation of the underwriter's fair dealing obligation under Rule G-17.

**Credit Default Swaps**. The issuance or purchase by a dealer of credit default swaps for which the reference obligations are securities of the issuers for which the dealer is serving as underwriter may pose a conflict of interest, because trading in such municipal credit default swaps, especially by those who do not own the reference obligations, has the potential to affect the pricing of the reference obligations, as well as the pricing of other securities brought to market by those issuers. Rule G-17 requires, therefore, that a dealer that engages in such activities must disclose that to the issuers for which it serves as underwriter.

**Retail Order Periods**

Rule G-17 requires an underwriter that has agreed to underwrite a transaction with a retail order period to, in fact, honor such agreement.[13] A dealer that wishes to allocate securities in a manner that is inconsistent with an issuer's requirements must not do so without the issuer's consent. In addition, Rule G-17 requires an underwriter that has agreed to underwrite a transaction with a retail order period to take reasonable measures to ensure that retail clients are *bona fide*. An underwriter that knowingly accepts an order that has been framed as a retail order when it is not (*e.g.*, a number of small orders placed by an institutional investor that would otherwise not qualify as a retail customer) would violate Rule G-17 if its actions are inconsistent with the issuer's expectations regarding retail orders. In addition, a dealer that places an order that is framed as a qualifying retail order but in fact represents an order that does not meet the qualification requirements to be treated as a retail order (*e.g.*, an order by a retail dealer without "going away" orders[14] from retail customers, when such orders are not within the issuer's definition of "retail") violates its Rule G-17 duty of fair dealing. The MSRB will continue to review activities relating to retail order periods to ensure that they are conducted in a fair and orderly manner consistent with the intent of the issuer and the MSRB's investor protection mandate.

**Dealer Payments to Issuer Personnel**

Dealers are reminded of the application of MSRB Rule G-20, on gifts, gratuities, and non-cash compensation, and Rule G-17, in connection with certain payments made to, and expenses reimbursed for, issuer personnel during the municipal bond issuance process.[15] These rules

are designed to avoid conflicts of interest and to promote fair practices in the municipal securities market.

Dealers should consider carefully whether payments they make in regard to expenses of issuer personnel in the course of the bond issuance process, including in particular but not limited to payments for which dealers seek reimbursement from bond proceeds or issuers, comport with the requirements of Rule G-20. For example, a dealer acting as a financial advisor or underwriter may violate Rule G-20 by paying for excessive or lavish travel, meal, lodging and entertainment expenses in connection with an offering (such as may be incurred for rating agency trips, bond closing dinners, and other functions) that inure to the personal benefit of issuer personnel and that exceed the limits or otherwise violate the requirements of the rule.[16]

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[1] The term "municipal entity" is defined by Section 15B(e)(8) of the Securities Exchange Act (the "Exchange Act") to mean: "any State, political subdivision of a State, or municipal corporate instrumentality of a State, including—(A) any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities."

[2] *See* Reminder Notice on Fair Practice Duties to Issuers of Municipal Securities, MSRB Notice 2009-54 (September 29, 2009); Rule G-17 Interpretive Letter – Purchase of new issue from issuer, MSRB interpretation of December 1, 1997, reprinted in MSRB Rule Book ("1997 Interpretation").

[3] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[4] *See* Fiduciary Duty of a Municipal Advisor, MSRB Notice 2011- (_____, 2011); Interpretive Guidance Concerning the Application of MSRB Rule G-17 to Municipal Advisors, MSRB Notice 2011-__ (_____, 2011).

[5] MSRB Rule D-9 defines the term "customer" as follows: "Except as otherwise specifically provided by rule of the Board, the term "Customer" shall mean any person other than a broker, dealer, or municipal securities dealer acting in its capacity as such or an issuer in transactions involving the sale by the issuer of a new issue of its securities."

[6] *See* MSRB Reminds Firms of Their Sales Practice and Due Diligence Obligations When Selling Municipal Securities in the Secondary Market, MSRB Notice 2010-37 (September 20, 2010).

[7] For example, a conflict of interest may exist when the underwriter is also the provider of a swap used to hedge a municipal securities offering or when the underwriter receives compensation from a swap provider for recommending the swap provider to the issuer. *See also* "Conflicts of Interest/Payments to or from Third Parties" herein.

[8] Underwriters who assist issuers in preparing official statements must remain cognizant of their duties under federal securities laws. With respect to primary offerings of municipal securities, the SEC has noted, "By participating in an offering, an underwriter makes an implied recommendation about the securities." *See* SEC Rel. No. 34-26100 (Sept. 22, 1988) (proposing Exchange Act Rule 15c2-12) at text following note 70. The SEC has stated that "this recommendation itself implies that the underwriter has a reasonable basis for belief in the

truthfulness and completeness of the key representations made in any disclosure documents used in the offerings." Furthermore, pursuant to SEC Rule 15c2-12(b)(5), an underwriter may not purchase or sell municipal securities in most primary offerings unless the underwriter has reasonably determined that the issuer or an obligated person has entered into a written undertaking to provide certain types of secondary market disclosure and has a reasonable basis for relying on the accuracy of the issuer's ongoing disclosure representations. SEC Rel. No. 34-34961 (Nov. 10, 1994) (adopting continuing disclosure provisions of Exchange Act Rule 15c2-12) at text following note 52.

[9] The MSRB has previously observed that whether an underwriter has dealt fairly with an issuer for purposes of Rule G-17 is dependent upon all of the facts and circumstances of an underwriting and is not dependent solely on the price of the issue. *See* MSRB Notice 2009-54 and 1997 Interpretation, *supra* note 3. *See also* "Retail Order Periods" herein.

[10] Rule G-13(b)(iii) provides: "For purposes of subparagraph (i), a quotation shall be deemed to represent a "bona fide bid for, or offer of, municipal securities" if the broker, dealer or municipal securities dealer making the quotation is prepared to purchase or sell the security which is the subject of the quotation at the price stated in the quotation and under such conditions, if any, as are specified at the time the quotation is made."

[11] *See* 1997 Interpretation.

[12] *See also* "Required Disclosures to Issuer" herein.

[13] *See* MSRB Interpretation on Priority of Orders for Securities in a Primary Offering under Rule G-17, MSRB interpretation of October 12, 2010, reprinted in MSRB Rule Book. The MSRB also reminds underwriters of previous MSRB guidance on the pricing of securities sold to retail investors. *See* Guidance on Disclosure and Other Sales Practice Obligations to Individual and Other Retail Investors in Municipal Securities, MSRB Notice 2009-42 (July 14, 2009).

[14] In general, a "going away" order is an order for new issue securities for which a customer is already conditionally committed.

[15] *See* MSRB Rule G-20 Interpretation — Dealer payments in connection with the municipal securities issuance process, MSRB interpretation of January 29, 2007, reprinted in MSRB Rule Book.

[16] *See In the Matter of RBC Capital Markets,* SEC Rel. No. 34-59439 (Feb. 24, 2009) (settlement in connection with broker-dealer alleged to have violated MSRB Rules G-20 and G-17 for payment of lavish travel and entertainment expenses of city officials and their families associated with rating agency trips, which expenditures were subsequently reimbursed from bond proceeds as costs of issuance); *In the Matter of Merchant Capital, L.L.C.,* SEC Rel. No. 34-60043 (June 4, 2009) (settlement in connection with broker-dealer alleged to have violated MSRB rules for payment of travel and entertainment expenses of family and friends of senior officials of issuer and reimbursement of the expenses from issuers and from proceeds of bond offerings).

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[1] All comments received will be made publicly available without change. Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Therefore, commenters should submit only information that they wish to make publicly available.

[2] *See* Reminder Notice on Fair Practice Duties to Issuers of Municipal Securities, MSRB Notice 2009-54 (September 29, 2009); Rule G-17 Interpretive Letter – Purchase of new issue from issuer, MSRB interpretation of December 1, 1997, reprinted in MSRB Rule Book.

[3] "Municipal entity" is defined in Section 15B(e)(8) of the Exchange Act as "any State, political subdivision of a State, or municipal corporate instrumentality of a State, including (A) any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities."

[4] *See* MSRB Interpretation on Priority of Orders for Securities in a Primary Offering under Rule G-17, MSRB interpretation of October 12, 2010, reprinted in MSRB Rule Book; *see also* MSRB Rule G-20 Interpretation — Dealer payments in connection with the municipal securities issuance process, MSRB interpretation of January 29, 2007, reprinted in MSRB Rule Book.

Alphabetical List of Comment Letters on MSRB Notice 2011-12 (February 14, 2011)

1. American Federation of State, County and Municipal Employees: Letter from Gerald W. McEntee, International President, dated April 11, 2011.

2. Bond Dealers of America: Letter from Mike Nicholas, Chief Executive Officer, dated April 11, 2011.

3. Municipal Regulatory Consulting: Letter from David Levy, Principal, dated April 11, 2011.

4. National Association of Independent Public Finance Advisors: Letter from Colette J. Irwin-Knott, President, dated April 11, 2011.

5. Securities Industry and Financial Markets Association: Letter from Leslie M. Norwood, Managing Director and Associate General Counsel, dated April 11, 2011.

AFSCME
We Make America Happen



April 11, 2011

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

Re: MSRB Notice 2011-14 Fiduciary Duty of Municipal Advisors
MSRB Notice 2011-13 Fair Dealing Obligations of Municipal Advisors
MSRB Notice 2011-12 Underwriters of Municipal Securities

Dear Mr. Smith:

The American Federation of State, County and Municipal Employees ("AFSCME") is the largest union in the AFL-CIO representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over $1 trillion. In addition, the AFSCME Employees Pension Plan (the "Plan") is a long-term shareholder that manages $850 million in assets for its participants, who are staff members of AFSCME and its affiliates.

AFSCME is pleased to have the opportunity to voice support for the rules proposed by the Municipal Securities Rulemaking Board ("MSRB") which delineate the fiduciary duty of municipal advisors with respect to their municipal entity clients, the obligations of municipal advisors to deal fairly with their current or prospective clients, and the requirements that underwriters have towards issuers of municipal securities. We applaud the efforts of the MSRB to protect municipal entities from self-dealing and other deceptive practices. Strong protections are required for municipal entities.

During consideration of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), AFSCME strongly supported the inclusion of provisions establishing the strongest possible market reforms, oversight and transparency for the "shadow markets" and other major provisions addressing corporate governance and investor protection. Investor protections important to AFSCME members include new market reforms addressing the sale of derivatives products and strategies, duties owed by firms and individuals offering investment advice, greater transparency for the

**American Federation of State, County and Municipal Employees, AFL-CIO**
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advisors to hedge funds and private equity investments, and improved safeguards for municipal markets.

In each of these rulemaking contexts, vendors of various investment products and services have raised concerns that new obligations of disclosure or other investor protection remedies are not workable. Perhaps unsurprisingly, many Wall Street firms and their different lobbying entities argue that new investor protections under Dodd Frank may also trigger obligations under federal pension law. The implementation of market reforms requires both coordinated rulemaking designed to facilitate the operation of well-functioning markets that deserve investor confidence, and a big picture view that prevents evasion by those who would delay and dilute market reforms. We urge the MSRB to keep both of these in mind.

One of the areas targeted by tactics of delay and misdirection is the definition of "investment advice." During passage of Dodd-Frank, workers, seniors, consumers, savers, and investors joined together to urge that the law be strengthened regarding the responsibilities of those who give investment advice, that it be "clarified" where doubt had been raised, and that it be expanded to areas – for example, over-the-counter derivatives – where it has become painfully clear that restrictions on sound market requirements were ill-advised, to say the least.

Entities that give investment advice sell both advice and products (or products and services) bundled together. These firms and their subsidiaries or affiliates sell advice, and products to "implement" that advice, in more than one market. Distinguishing advice from the products it recommends is hard to do. Identifying the accountable provider – the firm with the household name or the call center employee who answers the phone – is hard to do. Distinguishing the price of advice from the price of the product or service – and further distinguishing those prices from the amount "at work in the market" – is hard to do. Distinguishing who got paid what and works under what incentives is hard to do. Distinguishing when the worker or pension plan trustee or buyer responsible for other people's money is talking to an advisor, or another kind of provider, is hard to do. Knowing which hat is being worn by which affiliate is hard to do.

After reviewing the comments submitted by large financial firms to the different regulators, and the efforts to create cover for rolling back reforms one more time through the same old tricks of deregulating and defunding, it is hard to imagine that this difficulty is not exactly their goal. Regulators must be steadfast in order to cut through the smokescreen which permits financial firms to continue operating with serious conflicts of interest, to the detriment of investors.

In spite of the great overlap in the entities that provide advice and products (or strategies) in different markets, Wall Street firms argue that the differences are

huge and that any potential overlap in duties must be avoided. They prefer to redefine – or not define – "advice" anew in every market and every context. They limit the definition of the recipients eligible to receive the duty that comes with providing advice. They work to limit the types of products and strategies to which any advice-related duty could apply. They work to craft language limiting the application of any duty.

The harms to be avoided are always alleged to be these: too much disclosure risks seller liability; sellers withdrawing from the market; competition forces diminishing; investor choice narrowing; and prices rising. So, the argument goes, too much disclosure is bad for investors. We find this difficult to believe, and we urge you to take a very hard look at this logic.

When pension assets are involved, firms that seek to avoid their obligations warn that too much information disclosed by service providers may result in misunderstandings and promote bad decisions. It may intrude on proprietary information (meaning they have no obligation to tell clients), it certainly will cost sellers to disclose more, and they certainly would have to bill investors for that.

The challenges around implementing effective fiduciary duties are clearly present in the ongoing efforts at the MSRB. Dodd-Frank directs the MSRB to establish rules with respect to municipal advisors that "prescribe means reasonably designed to prevent acts, practices, and courses of business as are not consistent with a municipal advisor's fiduciary duty to its clients." And MSRB Notice 2011-14 requesting comment on draft guidance on a fiduciary duty of municipal advisors attempts to do that.

Yet the text itself warns that this guidance was developed based on the statutory language of Dodd-Frank, and that it was developed "without regard to any interpretation of that term proposed by the SEC in its proposed permanent registration rule for municipal advisors", and that MSRB may revise its own proposed guidance and may seek additional comment. Furthermore, the SEC proposal does not define exactly what constitutes the "provision of advice" though it gives examples of the types of "advice" that would trigger "municipal advisor" status and a duty to register under the proposal. At this time there is little that appears definitive. Careful review of the whole record – and continued input - will be very important.

MSRB noted several very important issues in the comment it submitted to the SEC regarding the definition of municipal advisor for purposes of SEC registration. Given the importance of these issues to AFSCME members, and the interplay with the scope of the fiduciary duty on municipal advisors addressed in this rulemaking proposal, we would like to address them here.

First, the MSRB noted that the SEC's proposed rule would benefit from a wording change to narrow the exclusion from municipal advisor registration for CFTC-Registered Commodity Trading Advisors in order to clarify that the exclusion "is available only when the registered commodity trading advisor is providing advice relating to swaps (as defined in Section 1a(47) of the Commodity Exchange Act and Section 3(a)(69) of the Exchange Act, and the rules and regulations thereunder." In other words, "the exclusion would not be available to such registered commodity trading advisors engaged in any other municipal advisory activities, including providing advice relating to any municipal derivative other than a swap".

The MSRB also provides several additional comments that show the complexity of the connection among investment advice obligations:

> The MSRB notes that Section 913 of Dodd-Frank and the effort to hold brokers to a fiduciary standard when giving advice comes into play in this marketplace and that "the Commission may, by rule, provide that the legal standard for securities transactions effected by broker-dealers with municipal entities shall be the same as the standard applicable to investment advisers under the Investment Advisers Act and, pursuant thereto, could replace the existing suitability standard with a fiduciary standard." SIFMA and others have urged that the SEC be given time to act first.
>
> The MSRB further noted its belief that public defined contribution pension plans fall squarely within the description of "investment strategies" and investment activities that trigger SEC registration of municipal advisors. The MSRB also "believes it would be appropriate to include public defined benefit pension plans as well, since they share many of the same potential direct or indirect impact on third-party beneficiaries and generally are exempt from the protections afforded by the Employee Retirement Income Security Act (ERISA) to private pension funds. Thus, in general, investment strategies would include such strategies relating to investments by all types of public pension funds other than broker-dealer recommendations "about a transaction such broker-dealer itself effects that is subject to federal broker-dealer suitability and related business conduct standards."
>
> Finally, the MSRB notes its reading of the language and legislative history of Dodd-Frank as "strongly indicative of a Congressional intent that advice by advisors to municipal entities, particularly in but not necessarily limited to the context of a municipal securities offering, was intended to be regulated under a single comprehensive municipal advisor regulatory construct", under which CFTC would be responsible for "comprehensive regulation . . . of the swap activities of swap dealers and major swap participants (including advice on swaps provided to special entities)", and MSRB would provide for

> "comprehensive regulation . . . of most typical non-dealer advisors to municipal entities (including advisors, other than swap dealers and major swap participants, providing advice on municipal derivatives).'

The MSRB says that strengthened coordination among the MSRB, the SEC and the CFTC would promote a more efficient and effective implementation of the Dodd-Frank Act and would reduce the compliance burden on market participants. This includes small municipal advisors who might provide advice to an issuer on a variable rate demand offering (VRDO) involving an interest rate swap which could be subject to MSRB rules as a municipal advisor in connection with advice on the new issue offering, while simultaneously becoming subject to distinct CFTC rules as a commodity trading advisor in connection with the swap. We again encourage such coordination among the agencies.

Another danger to avoid is that some sellers will carve themselves out of disclosure duties, that they will succeed in scaling back the reach of market reforms and staggering the effective dates, and fall artfully between the cracks. This would leave investors in a "buyer beware" bind, which might be filled by small independent advisors. These small firms would end up stepping into the disclosure breach and facing potential responsibility for unearthing the truth that sellers did not reveal.

The MSRB strongly recommends coordination. That is essential – not delay but real coordinated rulemaking. As a part of that process, both during rule development and after specifics are finalized, the MSRB, the SEC and the CFTC should undertake a series of efforts – similar to those typical of the Department of Labor's ERISA regulators - to issue not only clear explanations of their formal guidance but also informal guidance in the form of Frequently Asked Questions, regional meetings and internet webinars and other forms of explanation that help the market participants – including workers, pension participants, investors, and pension trustees – make informed decisions, knowing both the players and the rules.

Another MSRB Notice, 2011-12, requests comments on proposed interpretive guidance regarding the duty of dealers in their interactions with municipal entities as underwriters of municipal securities, "including integrally-related activities, such as interest rate swap transactions and purchases of defeasance escrow securities". The MSRB states that this duty to deal fairly requires, among other things, disclosure of all material risks and characteristics of the financing of complex municipal securities (such as a VRDO with a swap), as well as disclosure of any incentives for the underwriter to recommend the financing (e.g., third-party payments, certain credit default swaps, and profit-sharing arrangements with investors).

The duty of fair dealing here is also defined as including "an implied representation that the price an underwriter pays to an issuer bears a reasonable relationship to the prevailing market price of the securities. An underwriter's direct and indirect compensation for a new issue must not be excessive (i.e., disproportionate to the nature of the underwriting and related services performed)."

It seems reasonable to anticipate that this notice, too, will require coordination to ensure effective implementation and investor protection. Only that kind of coordinated implementation will fulfill the promise of Dodd-Frank and build back greater trust in the integrity of the financial markets and greater stability in the economy overall.

* * *

We appreciate the opportunity to express our views on this matter. Should you have questions regarding our comments, please contact Lisa Lindsley at (202) 429-1275.

Sincerely,

GERALD W. McENTEE
International President

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April 11, 2011

VIA ELECTRONIC MAIL

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

**Re: MSRB Notice 2011-12: Draft Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities**

Dear Mr. Smith:

The Bond Dealers of America (the "BDA") is pleased to offer comments on the Municipal Securities Rulemaking Board ("MSRB") Notice 2011-12: Draft Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities (the "Proposal"). The BDA is the Washington, DC based trade association representing securities dealers and banks focused primarily on the U.S. fixed income markets.

The BDA supports the MSRB's efforts to provide guidance to underwriters under Rule G-17. The BDA is concerned, however, that regulatory review and enforcement based on some aspects of the Proposal will be subject to hindsight bias. A review of the reasonableness of an underwriter's beliefs and actions after-the-fact could cause the underwriter's actions to be unfairly second-guessed despite the underwriter in fact having acted in good faith. Clarity is the best protection for issuers, underwriters and the municipal market. As further discussed below, the MSRB should clarify how underwriters may meet their "fair dealing" obligations with respect to each aspect of the Proposal.

As a general matter, the BDA questions whether the Proposal is issued prematurely given the current status of ongoing rulemakings by the Commodity Future Trading Commission ("CFTC") and Securities Exchange Commission ("SEC") regarding swaps and swap advisors and the SEC proposed rulemaking regarding municipal advisors. The Proposal should not conflict with or be duplicative of these or other regulations. Especially with respect to the duties of municipal advisors and underwriters, the Proposal should not create potentially overlapping obligations given the uncertain outcome of CFTC and SEC proposed rulemakings.

Fair Pricing

The Proposal provides that the duty of fair dealing "includes an implied representation that the price an underwriter pays to an issuer bears a reasonable relationship to the prevailing market price of the securities." Issues of municipal securities that otherwise appear to be equivalent are often priced quite differently by market participants due to distinctions that may not be readily apparent especially after the fact. If applied literally, this subjective standard is particularly problematic with respect to initial purchases from issuers because there is no prevailing market for newly issued municipal securities. Comparisons to secondary markets are difficult because of differences among issuers. Even for the same issuer differences between the securities result in different "prevailing market prices." This situation is further exacerbated if the secondary market is one that sees small and infrequent trades, which is often the case for municipal securities. Whether a dealer acted consistent with an implied representation to obtain the "best" or "most favorable" price (those terms are used, we believe, for the first time here) is a subjective determination based on multiple factors, some of which may be difficult to document. The MSRB should employ a standard that underwriters act in good faith with respect to the pricing of municipal securities.

Credit Default Swaps

The Proposal would require the disclosure to the issuer of the issuance or purchase by a dealer of credit default swaps ("CDS") for which the reference obligations are securities of the issuer for which the dealer is serving as underwriter. The MSRB should confirm that a general disclosure is sufficient rather than requiring the underwriter to specifically disclose that it is in fact engaged in such trading. A municipal underwriting desk is normally not aware of CDS trading by other desks in the institution and may be prohibited from finding out about such positions due to "information wall" policies that prohibit the sharing of such information within the firm. Accordingly, the MSRB should clarify that a general disclosure is acceptable if an underwriter notifies an issuer that the underwriter may engage in such trading from time to time.

Payment to or from Third Parties

The Proposal requires an underwriter to disclose to the issuer payments received by the underwriter in connection with its underwriting of the new issue *from* parties other than the issuer, and payments made by the underwriter in connection with such new issue *to* parties other than the issuer. The BDA notes that retail distribution and selling group agreements are normally disclosed in official statements. The BDA requests that the MSRB clarify whether there are other specific types of arrangements that the MSRB intends underwriters to disclose to issuers. The MSRB should also clarify that arrangements to issue tender option bonds and similar arrangements are not required to be disclosed to issuers by underwriters, or that generic disclosure is sufficient.

Retail Orders

The Proposal requires that underwriters take reasonable measures to ensure that retail clients are bona fide and underwriters otherwise honor agreements with issuers regarding retail order periods. Just what those "reasonable measures" are is not specified nor even an illustration given. The MSRB should provide some guidance about just what those reasonable measures are. The focus should be on the underwriter complying with the issuer's requirements with respect to retail customers and retail order periods. There must be a practical recognition of the difficulties in determining whether a purchaser intends to hold securities or to resell them. Further, underwriters rely on members of their selling groups in syndicated offerings. Accordingly, the MSRB should confirm that representations from selling group members adequately demonstrate that an underwriter took reasonable measures to ensure that retail clients are *bona fide*. As with other aspects of the Proposal, underwriters would otherwise be subject to after-the-fact second guessing.

Disclosures to the Issuer

The Proposal requires that disclosures to issuers must be made in writing to officials of the issuer with the authority to bind the issuer by contract with the underwriter. An underwriter could not truly make the determination of an official's authority without an analysis of state and local law, resolutions, delegations of authority and other such documents. BDA recommends that the MSRB clarify that an underwriter satisfies this duty if it reasonably believes that the official has the requisite authority, and in particular if the official represents that he or she has the authority to bind the issuer.

Thank you for this opportunity to present our views. Please do not hesitate to call if you have any questions.

Sincerely,

Mike Nicholas
Chief Executive Officer

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April 11, 2011

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

Sent via email to CommentLetters@msrb.org

Re: MSRB Notice No. 2011-12: 2011-13; 2011-14

Dear Mr. Smith:

Thank you for the opportunity to comment on the various matters included within the Requests for Comment on MSRB's Rules G-36 and G-17. Municipal Regulatory Consulting LLC is a professional consulting firm serving the municipal securities industry. In providing regulatory advice to municipal advisors and broker-dealers, I am sometimes called upon to interpret rules of the MSRB and other agencies or SROs. More to the point, my clients often seek advice how to apply those rules in the context of their business.

If anything is clear at this point in the rulemaking process spurred by the Dodd-Frank Act, it is that nothing is clear. Virtually all the rules and guidance proposed by the MSRB in 2011 come with the following explicit or implicit caveat: "Until the SEC settles on a definition that everyone can understand, even we (the MSRB) aren't certain what specific activities qualify as municipal advisory activities, nor do we know for certain when they begin. If we don't know which activities are advisory, we also don't know exactly who the advisors are. But we've been told we have to propose rules, so here they are." Market participants may have sympathy for the position in which the MSRB finds itself, but they have to react to what has been proposed, and many wonder given the circumstances why the MSRB has not chosen to be more circumspect.

I believe the proposals as written do not resolve but exacerbate confusion among market participants, including issuers, and create potential compliance nightmares. The MSRB would do the municipal securities community – including the issuers it is now mandated to protect – a great service if it scales back its proposals, moderates some of its positions and clarifies others.

**1. The MSRB Should Do No More than Establish Guiding Principles**

The MSRB does well by taking a minimalist approach to Rule G-36. "In the conduct of its municipal advisory activities on behalf of municipal entities, a municipal advisor shall be subject to a fiduciary duty, which shall include a duty of loyalty and a duty of care." It is obviously modeled after Rule G-17, which reads, "In the conduct of its municipal securities or municipal

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advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

Unfortunately, the MSRB goes too far and too deep in its efforts to address as many different aspects of the duties of loyalty, care and fair dealing as it can. The goal at this stage in the regulatory cycle, with certain market participants subject to rules and regulations for the first time, should be to promulgate rules everyone can understand and with which they can readily comply. Now is a time for establishing guiding principles. There will be plenty of time later for crawling in the weeds.

For example, the MSRB appropriately addresses the duty of loyalties and care by stating its view of the general principles underlying each. The duty of loyalty "requires the municipal advisor to deal honestly and in good faith with the municipal entity and to act in the municipal entity's best interests without regard to financial or other interests of the municipal advisor." The duty of care requires a municipal advisor to "exercise due care in performing its responsibilities."

The MSRB also does the regulated community a service by aggregating in a series of footnotes a variety of cases in which individuals or firms were found to have violated their fiduciary duty or fair dealing obligations under federal and state law and/or securities regulation. It would be reasonable for the MSRB to state that the activities with which the defendants in those cases were charged would violate Rule G-36 and/or Rule G-17. At least for now, however, the MSRB should stop there.[1]

**2. If the MSRB Wishes to Regulate Specific Market Activities, It Should Do So In Rules Designed Specifically to Address that Activity**

*a. Issues Relating to Advisory Contracts Should Be Addressed in Rule G-23*

In my view, the MSRB unreasonably intrudes on the commercial relationship between issuers and advisors when it specifies exactly who needs to say what to whom and when. The error is compounded because the MSRB fails to allow for variance when the facts and circumstances suggest that another approach would better accomplish the stated goals. Indeed, the MSRB's rigid requirements might even have the (presumably) unintended consequences of confusing issuers and creating an unlevel playing field between advisors and underwriters.

[1] An argument can be made that going one step further, *i.e.*, stating as a general proposition that material conflicts of interest should be disclosed, would not be one step too far, but stepping on that slippery slope led to the MSRB sliding all the way down the hill. Micromanaging the disclosure requirements – especially the ones relating to compensation - as the MSRB does would be difficult to justify even after time has passed; at this stage of the process, it makes no sense at all.

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For many years, the MSRB had a straightforward approach to when and under what circumstances a financial advisory relationship existed between an issuer and a dealer firm. In Rule G-23, it said

> (b) *Financial Advisory Relationship.* For purposes of this rule, a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of such services. Notwithstanding the foregoing, a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities.
> (c) *Basis of Compensation.* Each financial advisory relationship shall be evidenced by a writing entered into prior to, upon or promptly after the inception of the financial advisory relationship (or promptly after the creation or selection of the issuer if the issuer does not exist or has not been determined at the time the relationship commences). Such writing shall set forth the basis of compensation for the financial advisory services to be rendered, including provisions relating to the deposit of funds with or the utilization of fiduciary or agency services offered by such broker, dealer, or municipal securities dealer or by a person controlling, controlled by, or under common control with such broker, dealer, or municipal securities dealer in connection with the rendering of such financial advisory services.

For some reason, the MSRB did not extend Rule G-23 to non-dealer municipal advisors and/or modify Rule G-23 to address what it views as shortcomings in the contents of advisory contracts. Instead, the MSRB chose to make the content and context of written disclosures a subject of interpretive guidance under the rubric of fiduciary duty and fair dealing. If the MSRB feels so strongly that it needs to specify what goes in contracts, I submit that it should do so by rule and not by interpretation, and subject that proposal to the usual scrutiny and process that apply to rule changes.

*b. Issues Relating to Appropriateness or Suitability Should Be Addressed in Rule G-19*

The MSRB also has a rule that relates to the obligations of dealers when they recommend transactions to customers. The rule even distinguishes among (i) institutional accounts and non-institutional accounts and (ii) discretionary accounts[2] and non-discretionary accounts. Rule

[2] It is generally accepted that firms have a fiduciary duty with respect to discretionary accounts, though the term fiduciary does not appear anywhere in Rule G-19.

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G-19 imposes obligations on dealers to obtain certain information about its customers and about the products it offers before making any recommendations to customers.

As was the case with contracts, for some reason the MSRB chose not to address recommendations to municipal entity or obligated person clients by amending Rule G-19. Instead, the MSRB proposes to address these issues by issuing interpretive guidance under Rules G-36 and G-17. What is worse, it uses language utterly foreign to municipal regulation. Thus, depending on the circumstances and whether the client is a municipal entity or an obligated person, an advisor might have one or more of the following duties:

- To investigate and advise the municipal entity of alternatives to the proposed financing structure or product that are then reasonably feasible based on the issuer's financial circumstances and market conditions at the time, if those alternatives would better serve the interests of the municipal entity.
- To make a reasonable inquiry as to the facts that are relevant to a municipal entity's determination of whether to proceed with a course of action.
- To act competently and provide advice to the municipal entity after making reasonable inquiry into the representations of the municipal entity's counterparties, as well as then reasonably feasible alternatives to the financings or products proposed that might better serve the interests of its municipal entity client.
- To recommend a transaction or product only if it has concluded, in its professional judgment, that the transaction or product is appropriate for the client, given its financial circumstances, objectives, and market conditions, and advise the client of material risks and characteristics of the structure or product.

If the MSRB believes that municipal advisors have an obligation to municipal entity and obligated person clients to "know their customer," and to have a "reasonable basis" for recommending transactions, products or courses of action, the MSRB should abandon the multiple and confusing formulations quoted above.[3] The MSRB should simply say what it means in Rule G-19 and it should use terminology the industry already understands.[4]

### 3. The MSRB Should Abandon Appendix A Altogether

Even if the MSRB accepts my suggestion and chooses to address advisor compensation directly in Rule G-23 instead of in interpretive guidance under fiduciary duty or fair dealing, it should get rid of its inappropriate and ill-conceived attempt to demonstrate that all compensation

[3] The same principle applies to the MSRB's disclosure requirements in the context of "complex municipal securities financings," although it does not appear that the MSRB has imposed upon underwriters any suitability or appropriateness obligations when recommending any financing, complex or otherwise. Whatever the requirements, they should be set forth in Rule G-19.

[4] Among the advantages of using Rule G-19 is that there is a wealth of existing interpretive guidance relating to the concept of suitability and what is required to have a reasonable basis for making a recommendation.

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creates conflicts between advisors and issuers. The MSRB does indeed have a mandate to protect issuers, but it seems to me that there are many more important things to worry about than whether an advisor being paid by the hour is padding her bill. And there are better ways to do it than requiring a senior issuer official to attest in writing that he understands this "conflict" and is OK with going ahead anyway.

**Conclusion**

Writing guidance to establish the parameters of fiduciary duty and fair dealing is not easy. The MSRB should not make the task more difficult than it is by trying to fit so many things into boxes not designed to hold them. Instead, it should concentrate on establishing guiding principles and use the existing regulatory structure where possible to address specific concerns.

Very truly yours,

David Levy, Principal

cc: Martha Haines, SEC

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April 11, 2011

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

Re: MSRB Notice No. 2011-12

Dear Mr. Smith:

The National Association of Independent Public Financial Advisors ("NAIPFA") appreciates this opportunity to provide comments to the Municipal Securities Rulemaking Board ("MSRB") on the MSRB's proposed interpretation of Rule G-17 as it would apply to underwriters (the "UW Guidance").

NAIPFA, founded 21 years ago, is a professional organization composed of independent public finance advisory firms located across the nation. Our member firms solely and actively represent the interests of issuers of municipal securities.

**PRELIMINARY STATEMENT:**

The MSRB issued concurrently three Requests for Comment, one proposing new Rule G-36 on the fiduciary duty of municipal advisors, another applying existing Rule G-17 to the municipal advisory relationship between advisors and obligated persons, and the third applying existing Rule G-17 to underwriters. In a separate letter also filed today, NAIPFA commented extensively on the two releases that focused on the activities of municipal advisors. In this comment letter, NAIPFA addresses its concerns about the MSRB's approach to underwriters.

NAIPFA could not object more strongly to the approach the MSRB has taken in attempting to implement the Dodd-Frank Act. The fiduciary duty and fair dealing proposals, read together with the guidance recently proposed on Rule G-23, demonstrate a consistent effort to flip Congressional intent on its head by explicitly and implicitly demonizing municipal advisors while permitting underwriters to engage in the same practices that, in large part, led Congress to intervene in the municipal market in the first place. Congress told the MSRB that issuers needed protection from predatory financial firms who had material conflicts of interest, but the MSRB seems bent on protecting them only from independent advisors who do not have material conflicts and whose interests have always been – and will continue to be – aligned with their issuer clients.

The MSRB has got it backwards. The Board contends that "fair dealing" requires advisors to disclose in writing that getting paid by the hour creates a potential conflict because the advisor would then have an incentive to work more hours, yet for most financings the MSRB imposes no similar

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requirement on underwriters to disclose all the different conflicts they have and the ways in which they potentially profit from their relationship with the issuer or obligated person client. All the underwriter needs to do is say "I'm an underwriter" and avoid saying "I'm acting in your best interests" and it is free to give the kind of advice that, if given by any other party, would carry with it a fiduciary duty. It is not just the will of Congress, but common sense that should dictate a different approach.

**CONTEXT:**

The issues NAIPFA raises are not academic. This isn't about professors coming up with interesting fact patterns for business or law school final exams. NAIPFA members live in the real world, and the issues about which we are arguing are ones NAIPFA members face every day.

Let us begin with real world examples. The first is the recent G-23 comment letter submitted by independent advisor (and NAIPFA member) Ehlers, a copy of which is attached as Exhibit A, in which Ehlers describes how one financial services firm that provides both advisory and underwriting services distinguishes underwriters such as itself from pure financial advisory firms.

"Today I viewed a power point presentation made by an underwriter to a state school association. They explained bond terminology for school officials with the following exact descriptions.
*Financial Advisor: 1. Firms that work with Bond Issuers to develop the plan of finance. 2. Role: Assist the bond issuer with implementation of the finance plan. The Financial Advisor helps determine the structure and terms for a bond issue while preparing the bond issue to access the bond market.*
*Bond Underwriter: 1. Firms that buy bond issues from bond issuers with the intent to resell them to bondholders. 2. Role: Purchasing and selling bond issue to potential bondholders who are bidding to purchase portions of the bond issue. As underwriters, firms often employ Public Finance professionals who understand the bond market and other public funding sources to work directly with bond issuers* ***providing similar services to those offered by Financial Advisors.***"

The second is an unsolicited letter from a financial services firm to a client of a NAIPFA member firm, a copy of which is attached as Exhibit B, in which the underwriter attempts to convince an issuer which has already retained an independent financial advisor that its interests would be better served by getting rid of the advisor and hiring the firm as its negotiated underwriter.

The firm describes itself as "a proven leader" in public finance "committed to providing the best financial advice through a combination of deep expertise, broad resources and unwavering client focus to the communities it serves." It then goes on to describe itself as "a full service financial advisory firm with underwriting capabilities." Nowhere in the letter does the firm mention that it is not seeking to act as financial advisor for this issuer. Nowhere does the firm state that in its role as underwriter it would not have a fiduciary duty or that the advisor it seeks to supplant does have such a duty. And the firm certainly does not disclose any of the inherent conflicts of interest that all underwriters have.

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Most striking is that this letter was not written in March 2005 or even in March 2010. It was written ***just a few days ago***, long after Dodd-Frank was enacted and after the MSRB had issued requests for comment on Rules G-23, G-36 and G-17.

But what if the issuer is confused and later learns that the bond deal the underwriter recommended was actually not the best deal it could have gotten? The underwriter has got that covered, because the industry has developed a way to protect itself. SIFMA has crafted language for its members to insert in bond purchase agreements that would "clarify" the role of the underwriter and the limitations on its duties to the issuer:

**No Advisory or Fiduciary Role.** The [Issuer/Company] acknowledges and agrees that: (i) the transaction contemplated by this [name of agreement] is an arm's length, commercial transaction between the [Issuer/Company] and the [Name of Firm] in which [Name of Firm] is acting solely as a principal and is not acting as a municipal advisor, financial advisor or fiduciary to the [Issuer/ Company]; (ii) [name of Firm] has not assumed any advisory or fiduciary responsibility to the [Issuer/Company] with respect to the transaction contemplated hereby and the discussions, undertakings and procedures leading thereto [(irrespective of whether [Name of Firm] has provided other services or is currently providing other services to the [Issuer/ Company] on other matters)]; (iii) the only obligations [name of Firm] has to the [Issuer/Company] with respect to the transaction contemplated hereby expressly are set forth in this [name of agreement]; and (iv) the [Issuer/Company] has consulted its own legal, accounting, tax, financial and other advisors, as applicable, to the extent it has deemed appropriate.[1]

In other words, after the underwriter has gotten the assignment, and after the deal is virtually done, an issuer official will be presented with a bond purchase agreement to execute in which, perhaps for the very first time, he or she will be told that the firm on which it relied to do the right and best thing for the issuer has expressly disclaimed any obligation for doing so. Moreover, it is also demanding that the issuer acknowledge in writing that it consulted with its own advisors – including the financial advisor fired at the underwriter's suggestion!

This is the way business is conducted today in the real world.

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[1] See *Clarifying Statement*, found at http://www.sifma.org/Services/Standard-Forms-and-Documentation/Municipal-Securities-Markets/

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**COMMENT:**

The MSRB believes that fair dealing requires "disclosure of material conflicts of interest, such as those that may color its judgment and impair its ability to render unbiased advice to its client." The MSRB further proposes that such disclosures be made in writing to certain officials "in a manner sufficiently detailed to inform the [client] of the nature and implications of the conflict." That is what it says in its draft Interpretive Notice Concerning the Application of MSRB Rule G-17 to Municipal Advisors. Unfortunately, the MSRB seems to believe this requirement applies ***only*** to municipal advisors, for one searches in vain for a similar requirement in the MSRB's Interpretive Guidance Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities.

NAIPFA simply cannot understand how or why the MSRB can impose such rigid requirements on advisors and give underwriters a pass. To be sure, the MSRB does impose certain minimal requirements on underwriters in the limited circumstance where they recommend a complex financing, but those obligations do not apply to the vast majority of transactions that are done by the vast majority of issuers. And NAIPFA fully expects that underwriters will argue that even the requirements the MSRB imposes in the context of complex transactions are unnecessary or over-reaching. They will say, as they have consistently in the past, "we are merely counterparties in an arm's-length commercial transaction, so don't make us do the kinds of things that fiduciaries have to do."

But when we return to the real world, NAIPFA member firms encounter the kinds of statements we pointed out above. In the real world, financial firms routinely do their best to make themselves look like the issuer's best friend. "We do everything the independent advisors do – and more!" So let's look at the marketplace as it would work if all the MSRB's proposals were implemented.

An independent advisor and an underwriter each have an idea for a refunding[2] they believe might be of interest to a municipal entity issuer, in this case a town, and the town is not presently a client. Each decides it would be a good idea to call on the town's deputy director of finance to present the idea. Each makes a call to set up a meeting. What steps would each need to take before being able to go to that meeting?

The advisor would need to do an internal review to determine if it had any potential conflicts with this issuer, because those conflicts would need to be disclosed. Assuming there were none identified, the advisor would still need to send the Compensation Disclosure Document (Appendix A). The advisor

[2] Some viewing this example might ask whether merely presenting a refunding idea constitutes advice such that it would trigger the application of the various fiduciary requirements. That a question this basic has yet to be definitively answered by the SEC at this time highlights the difficulty NAIPFA and others have responding meaningfully to the various rule proposals and guidance put forth by the MSRB.

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would need to investigate whether the deputy director has the authority to bind the town by contract. If the deputy has the requisite authority, it can send Appendix A to him; if he doesn't the advisor would need to send it to someone who has the appropriate authority. In either case, the advisor would have to wait until it received written consent back from the issuer before the meeting could go forward.

The underwriter could simply go to the meeting. At the meeting, she could hand out a nice glossy brochure that highlights all the wonderful services the firm offers, including advisory services. At some point during the meeting, in which she recommends doing the deal on a negotiated basis, all she would need to say is, "Please hire us to be your underwriter."

NAIPFA submits that this regime is so obviously flawed that it calls into question what the MSRB was thinking when it developed it. It clearly fails the most basic test of any regime that is supposed to implement the intentions of the Dodd-Frank Act, which is to protect issuers, and it skews the competitive landscape even more in favor of underwriters than it was before.

If the will of Congress is to be done, the MSRB needs to re-think its entire approach. NAIPFA continues to believe that the underwriter exception should not be read so broadly as to permit underwriting firms to provide advice without a corresponding fiduciary duty. Should the SEC determine that underwriters may do so, however, the MSRB must require underwriters to do at least what they are requiring advisors to do, which is to make clear in plain English "the nature and implications" of the various conflicts they have.

As NAIPFA urged in its comment letter on G-23, the centerpiece of any rational approach needs to be disclosure by underwriters of the facts that they:

- Are not acting as advisors but as underwriters;
- Are not fiduciaries to the issuer but rather counterparties dealing at arm's length;
- Have conflicts with issuers because they represent the interests of the investors or other counterparties which may result in benefits to other transaction participants at direct cost to the issuer;
- Seek to maximize their profitability and such profitability may or may not be transparent or disclosed to the issuer; and
- Have no continuing obligation to the issuer following the closing of transactions.

These disclosures need to be made to the same individuals, in the same manner and at the same time as any similar disclosures that the MSRB requires advisors to make. And if advisors need to receive written consent to these disclosures before they can discuss with a potential client the structure, terms, timing and other similar matters regarding a potential financing, underwriters should, too.

Underwriters must also be required - in the same manner and to the same extent as advisors are required – to have a reasonable basis for any recommendation they make and to disclose material risks about the course of conduct they recommend, along with the risks and potential benefits of reasonable alternatives then available in the market.

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**CONCLUSION:**

As it does in its companion letter submitted today, NAIPFA strongly urges the MSRB to re-think its proposals and take a different approach. Failing to do so would leave issuers in a worse position than they were before, more confused than less and more uncertain whom to trust. We respectfully submit that Congress intended – and issuers deserve – a different result.

Sincerely,

Colette Irwin-Knott

Colette J. Irwin-Knott, CIPFA
President, National Association of Independent Public Finance Advisors

cc: The Honorable Mary L. Schapiro, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
Michael Coe, Counsel to Commissioner Aguilar
Martha Haines, Assistant Director and Chief, Office of Municipal Securities
Lynnette Hotchkiss, Executive Director, Municipal Securities Rulemaking Board

Exhibit A

March 21, 2011

Elizabeth M. Murphy, Secretary
Securities and Exchange SEC
100 F Street, N.E.
Washington, DC 20549-1090

Re: File Number SR-MSRB-2011-03

Dear Ms. Murphy:

Today I viewed a power point presentation made by an underwriter to a state school association. They explained bond terminology for school officials with the following exact descriptions.

*Financial Advisor:*
*1. Firms that work with Bond Issuers to develop the plan of finance.*
*2. Role: Assist the bond issuer with implementation of the finance plan. The Financial Advisor helps determine the structure and terms for a bond issue while preparing the bond issue to access the bond market.*

*Bond Underwriter:*
*1. Firms that buy bond issues from bond issuers with the intent to resell them to bondholders.*
*2. Role: Purchasing and selling bond issue to potential bondholders who are bidding to purchase portions of the bond issue. As underwriters, firms often employ Public Finance professionals who understand the bond market and other public funding sources to work directly with bond issuers* ***providing similar services to those offered by Financial Advisors.***

I call your attention to the area in bold. The underwriter is telling issuers that underwriters are "providing similar services to those offered by Financial Advisors." I know this was not the intent of Dodd- Frank. Underwriters do not recognize the role of the financial advisor or recognize that their role is different than that of a Financial Advisor. I support the comments filed by NAIPFA and offer this as an example of why underwriters should not be able to provide the same advice as financial advisors.

I am happy to provide a copy of this presentation should that be helpful in your deliberations.

Sincerely

Steve Apfelbacher
President

EHLERS
LEADERS IN PUBLIC FINANCE

Offices also in Wisconsin and Illinois

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651-697-8555
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3060 Centre Pointe Drive
Roseville, MN 55113-1122

Exhibit B

March 22, 2011

Ms. [redacted], Clerk/Treasurer
City of [redacted]
211 W. [redacted] Street
[redacted]

RE: Refunding Opportunity

Dear Ms. [redacted]:

On behalf of [redacted] & Co. ("[redacted]"), we would like to thank you for the opportunity to offer our financial advisory services to the City of [redacted]. [redacted] is a proven leader in [redacted] public finance and is committed to providing the best financial advice through a combination of deep expertise, broad resources and unwavering client focus to the communities it serves.

As you may be aware [redacted] is a full service financial advisory firm with underwriting capabilities. When comparing [redacted] to other financial advisory firms it is important to understand this distinction. [redacted] has the ability to conduct either competitive or negotiated sales. This is important to the City because it is your financial advisor's role to recommend the method of sale for each transaction which achieves the lowest overall cost, considering all related fees including both financial advisor and underwriting fees.

[redacted] recommendation is to move forward with the issuance of $1,085,000 General Obligation Refunding Bonds through negotiated sale. [redacted] charges no financial advisory fee and would charge $10,000 as an underwriting fee along with $2,250 for preparation and distribution of the official statement.

[redacted]s underwriting abilities are unmatched in the State and nationwide. We have ranked as the No.1 underwriter for competitive and negotiated issues ($10mm or less) in the State of [redacted] since 2003. We are confident this approach will provide the lowest cost and therefore provide the greatest level of savings to the City.

We look forward to the opportunity to work with the City of [redacted]. Thank you for your consideration.

Sincerely,

sifma

*Invested in America*

April 11, 2011

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

**Re: MSRB Notice 2011-12 – Draft Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities (Feb. 14, 2011)**

Dear Mr. Smith:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to comment on the Municipal Securities Rulemaking Board's ("**MSRB**") draft interpretive notice concerning the application of MSRB Rule G-17 to underwriters of municipal securities (the "**Proposal**").

## I. Executive Summary

SIFMA supports the MSRB's desire to provide guidance to underwriters of municipal securities with respect to their "fair dealing" obligations. However, SIFMA believes that the MSRB should be careful not to transform the duty of fair dealing into a fiduciary-type obligation that imposes burdensome, expensive and unnecessary affirmative obligations by interpreting a prohibition on deception and fraud. Underwriters are not municipal advisors, and the standards applicable to each should be clearly distinguishable.

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

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In interpreting underwriters' duties, the MSRB should also avoid duplicating requirements to which underwriters currently are, or will soon become subject. For example, subjecting underwriters to disclosure obligations when recommending a derivative risks duplicating—or potentially conflicting—with the obligations underwriters will have under business conduct standards to be adopted by the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**"). Similarly, underwriters are already subject to various obligations under other regulatory regimes requiring them to have reasonable bases for representations they make, including potentially severe penalties for their failure to do so. Interpreting these obligations into the duty of fair dealing adds little additional protection to municipal entities, while creating additional uncertainty and risk to underwriters when their actions are reviewed in hindsight.

Further, the MSRB should reconsider imposing its judgment regarding necessary disclosures in the underwriting context. In most circumstances, municipal entity issuers understand and know how to make use of their bargaining power. Where a municipal entity believes disclosure of certain information would be useful, it can require that information to be disclosed as a condition in its request for proposals. Mandating disclosures that issuers do not want would simply add to the issuer's costs and creates paperwork burdens for underwriters, without providing any real benefits to municipal entities.

## II. Relationship with Rule G-36

Under Rule G-17, an underwriter is required to "deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice." The Proposal purports to expound upon this duty of fair dealing that an underwriter owes to municipal entity issuers. In a separate proposal, the MSRB has sought comment on draft Rule G-36 and a draft interpretive notice relating to the fiduciary duties that a municipal advisor owes to its municipal entity clients.[2]

### A. Rule G-17 Should Not Be Interpreted to Impose Fiduciary Obligations on Underwriters.

Section 975 ("**Section 975**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") distinguishes between municipal advisors, who are subject to a fiduciary duty when rendering advice to municipal entities under certain circumstances, and broker-dealers acting as

[2] *See* MSRB Notice 2011-14, Draft MSRB Rule G-36 (On Fiduciary Duty of Municipal Advisors) and Draft Interpretive Notice (Feb. 14, 2011).

underwriters, who are not subject to a fiduciary duty. Rather than recognizing these statutory distinctions, the Proposal, through interpretation, would apply elements of the fiduciary standard to ordinary underwriter activities. The Proposal goes beyond requiring underwriters to "deal fairly" and converts underwriters into a type of "fiduciary-lite," a heightened standard of duty far beyond the requirements of Section 975 and customary practice.

For example, under the Proposal, an underwriter that recommends a "complex" municipal securities financing that involves a derivative contract, an uncommon external index or other atypical arrangement that is integrally related to the financing must disclose all material risks and characteristics, as well as any incentives to recommend the transaction. Municipal entities that require an analysis of all material risks and characteristics of a transaction should either engage independent advisors, rather than relying upon underwriters, or contract specifically with underwriters to provide this service as part of their underwriting obligations. Moreover, underwriters, like other dealers in securities, should not be required to disclose all of their business relationships and methods of doing business, including their financial incentives, so long as they are not fraudulent or misleading.

### B. Underwriters That Are Also Municipal Advisors.

SIFMA notes that the SEC has proposed, but not yet adopted, rules interpreting activities that would require registration as a municipal advisor.[3] Although what the final SEC rules will require is still unknown,[4] the Pending SEC

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[3] *See* Exchange Act Release No. 63576 (Dec. 20, 2010) (the "**Pending SEC Proposal**").

[4] Given this uncertainty, SIFMA generally believes the adoption of any MSRB interpretations in this area are premature and should be deferred until the SEC rules are finalized. *See* Comment Letter from Leslie M. Norwood, SIFMA, to Ronald W. Smith, MSRB (April 11, 2011) (our "**G-36/G17 Letter**") at 3–4.

As noted in our G-36/G17 Letter, it is critical that the MSRB consider in its various rulemakings and interpretations, the relationship and, therefore, proper sequencing of the various pending SEC and MSRB proposals and requests for comment. This is particularly evident in the case of the Proposal and the MSRB's proposed interpretive guidance on Rule G-23 (the "**G-23 Interpretation**") and its impact on underwriters of municipal securities offerings. The proposed G-23 Interpretation would prohibit a dealer that provided "advice" in respect of a securities issue from acting as an underwriter on that issue. *See* Proposed Rule Amendments and Interpretive Notice Filed Regarding Rule G-23 on Activities of Financial Advisors, MSRB Notice 2011-10 (Feb. 9, 2011). If the proposed G-23 Interpretation is adopted, prospective underwriters would be at risk of being precluded from acting as an underwriter if their initial discussions with an issuer is deemed to constitute "advice." Yet, the SEC and the MSRB are still evaluating the question of what is considered "advice" in the context of municipal advisors. In the meantime, interested
(...continued)

Proposal could be interpreted to take a narrow view of the underwriter exception, such that the exception would only be available for actions within the core underwriter responsibilities.[5]

The MSRB should clarify how Rule G-17 will apply to underwriters of municipal securities in the event that the underwriter exception is ultimately interpreted very narrowly, and an underwriter is also deemed to be a municipal advisor for purposes of Rule G-36 with respect to its ancillary activities (such as recommending a swap that is integrally related to an underwriting). For example, when an underwriter performs both underwriting services and advises a municipal entity regarding a related swap, which activities will be governed by G-36 and which will be governed by G-17?

## III. Underwriter Disclosure Requirements

### A. Complex Municipal Securities Financings.

The Proposal would require that, where an underwriter of a negotiated issue recommends a financing that involves a (i) derivative (such as a swap), (ii) an atypical external index, (iii) unusual or variable issuer cash flows, or (iv) other atypical or complex arrangements integrally related to the financing, the financing would be considered "complex." Recommending a "complex" transaction would trigger additional disclosure obligations, such as "all material risks and characteristics" of the complex financing.

The MSRB should reconsider the types of transactions that it deems "complex." For example, municipal financings that have integrally related derivative components, such as an interest rate swap, are neither novel nor atypical. These types of transactions have become commonplace and are well understood by issuers. The municipal securities market has a history of transaction structures that were originally thought of as "complex" becoming extremely routine over the course of time.

Similarly, a transaction that may be "complex" to one issuer may not be "complex" to another issuer that enters into such transactions on a recurring basis. The MSRB should clarify that a transaction will only be deemed "complex"

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(continued...)
parties are unable to assess or comment on the full impact on business practices and activities of the proposed G-23 Interpretation or the Proposal until the SEC and the MSRB resolve what activities and communications constitute "advice."

[5] *See* SEC Proposal 31–32.

where the municipal issuer informs the underwriter that the issuer has never engaged in the type of transaction before and therefore may not understand the transaction's material risks and characteristics. Requiring underwriters to provide detailed disclosures about commonly understood transactions will not provide additional protection for municipal entity issuers but will only serve to raise the cost of the offering to the issuer.

In any case, the MSRB should provide further guidance and definition with regard to what types of transactions will be considered "complex." References in the Proposal to "external index not typically used in the municipal securities market" and "atypical or complex arrangements" are vague and insufficient to give underwriters notice or certainty as to when the special disclosures will be required.

### B. Requiring Disclosure Regarding Derivatives is Duplicative and May Be Inconsistent with Other Applicable Regulations.

As noted above, the Proposal would require underwriters that recommend "complex" financing transactions, such as those that include related swaps, to provide municipal entity issuers with disclosure regarding the material risks and characteristics of the swap.

In light of ongoing rulemakings by the CFTC and the SEC, the MSRB should defer the imposition of any disclosure requirements or other business conduct standards relating to swaps and security-based swaps, as these will be the subject of detailed requirements to be established by the CFTC and the SEC and were already provided for by Congress in Title VII of the Dodd-Frank Act.[6] If adopted, the Proposal would layer additional requirements on swap dealers and security-based swap dealers that could create multiple, duplicative and potentially conflicting obligations. Even in a circumstance where the underwriter is not, itself, a swap dealer or a security-based swap dealer, and is merely recommending and arranging a swap with a third party, it will be subject to CFTC- and SEC-established duties applicable to introducing brokers, futures commission merchants and broker-dealers.

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[6] *See* Commodity Exchange Act § 4s(h)(3) (adopted under Section 731 of the Dodd-Frank Act) ("Business conduct requirements adopted by the [CFTC] shall ... require disclosure by the swap dealer or major swap participant ... information about the material risks and characteristics of the swap...."); Securities Exchange Act § 15F(h)(3) (adopted under Section 764 of the Dodd-Frank Act); *see also* CFTC Proposed Rule, Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80638 (Dec. 22, 2010).

### C. Credit Default Swaps.

The Proposal would require that if an underwriter, in its dealer capacity, issues or purchases credit default swaps ("**CDS**") that reference the obligations of the municipal entity issuer, the underwriter must disclose those activities to the issuer.

The MSRB should reconsider this disclosure requirement because it is highly prejudicial to require underwriters to disclose their hedging and risk management activities. Such disclosure may hinder such risk management and potentially compromise counterparty relationships. Moreover, even without the Proposal, if a municipal entity issuer believes this type of disclosure is useful, the municipal entity issuer can request it, and prospective underwriters can determine whether they are willing to provide such information.[7] We note that, while the Proposal states that "trading in such municipal credit default swaps ... has the potential to affect the pricing of the reference obligations," an analysis by the California State Treasurer of trading by six major underwriters in CDS that referenced California general obligation bonds found that "CDS trading's [*sic*] effect on bond prices is not significant enough to cause concern at this time."[8]

If the MSRB retains this requirement, it should exempt dealing in CDS that reference a basket of securities that include the issuer's securities, among others. The conflict of interest concerns asserted in the Proposal are not applicable to CDS on a basket, which would have less impact—if any at all—on the pricing of each issuer's securities.

Finally, the MSRB should confirm that generalized disclosures for CDS activities are sufficient. Underwriters that are part of large financial institutions may not be aware of all the activities of other separate desks within the firm. Even if an underwriter is able to confirm in advance of an offering that the underwriter is not dealing in CDS of the issuer, it cannot know in advance whether it will do so in the future. The MSRB should therefore confirm that general disclosures are satisfactory so long as they put the issuer on notice of the possibility that the underwriter may, from time to time, engage in such dealing, rather than that the underwriter, in fact, is engaging in the activity.

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[7] We understand that a very small number of municipal issuers have, in fact, chosen to require this information be disclosed.

[8] *See* News Release, California State Treasurer Bill Lockyer, *Treasurer Lockyer Releases Data on Major Banks' Trading of Derivatives Linked to California Bonds* (Apr. 22, 2010), *available at* http://www.treasurer.ca.gov/news/releases/2010/20100422.pdf.

**D. Payments To or From Third Parties.**

The Proposal would interpret an underwriter's duty of fair dealing to require it to disclose to the municipal entity issuer any payments received by the underwriter from third parties in connection with the underwriting, and any payments made by the underwriter to third parties in connection with the underwriting, as well as the details of any "third-party arrangements for the marketing of the issuer's securities."

The MSRB should confirm that an underwriter need only *disclose* to an issuer payments to or from third parties in connection with an underwriting, but need not receive any form of consent from the issuer. The MSRB should also clarify the extent of the "details" regarding any third-party arrangements for the marketing of the issuer's securities that the underwriter must disclose to the issuer. SIFMA notes that third-party arrangements are typically already disclosed in the official statement.

Additionally, the MSRB should confirm that the term "third parties," for this purpose, refers to parties other than (i) the municipal entity issuer, and (ii) the underwriter and its affiliates. As such, internal payments or other internal credits among the underwriter and its affiliates would not be deemed to be a "third-party payment" and need not be disclosed. SIFMA believes that such internal arrangements do not raise the same risks of coloring a party's judgment that are concerns where payments are made between true third parties.

An underwriter should not be required to disclose to the issuer payments or other benefits received or given in relation to collateral transactions, such as credit default swaps, except where failure to do so would be fraudulent or constitute a misrepresentation. As noted above, an underwriter should be entitled to manage its risks without such disclosures. In addition, the proposed standard is highly inconsistent with the obligations of ordinary underwriters for non-municipal issuers under existing rules of the SEC and the Financial Industry Regulatory Authority.

**E. Official Receiving Disclosures.**

The Proposal would require an underwriter to make the required disclosures to an official of the municipal entity issuer who has the authority to bind a municipal entity.

The MSRB should clarify what level of diligence an underwriter would be required to undertake in order to determine whether the official receiving the disclosures has "authority to bind the issuer by contract with the underwriter." In

practice, underwriters may deal with officials of the issuer who do not have the authority to bind the issuer in relation to the issuance of securities, but who are nonetheless sufficiently senior in stature to be capable of understanding and taking action, if necessary, in relation to such disclosure.

An underwriter should not be viewed as having breached its duty of fair dealing simply because it erred in its understanding of the signing authority of a municipal entity issuer's official. Instead, SIFMA suggests that an underwriter's reasonable belief that the official has such authority should satisfy its duty. A representation to this effect by the receiving official should be a sufficient basis for the underwriter to form this reasonable belief, absent the underwriter's actual knowledge that such representation is false.

### F. Disclosures Need Not Be Repeated.

The MSRB should confirm that, with respect to any information that would be required to be disclosed under the Proposal, an underwriter need not re-disclose such information if the information was contained in the underwriter's response to a municipal entity issuer's request for proposals or otherwise provided to the issuer before the underwriter was formally engaged.

## IV. Underwriter "Reasonable Basis" Diligence Obligations

### A. Provision of a Certificate.

Under the Proposal, an underwriter would be required to have a "reasonable basis" for providing representations and material information in a certificate that will be relied upon by the municipal entity issuer or other relevant parties to an underwriting (*e.g.*, an issue price certificate).

The MSRB should reconsider this interpretation. An underwriter's basis for its provision of an issue price certificate is not a matter properly considered to be within an underwriter's duty of fair dealing to a municipal entity issuer. In any case, existing laws assure that underwriters do not provide issue price certificates without a reasonable basis, and sufficient penalties already exist if an underwriter were to do so. For example, an underwriter could be subject to substantial penalties under Section 6700 of the Internal Revenue Code if, in connection with facilitation of a municipal bond offering, it makes a statement that will be relied on for determining the tax-exempt status of the bonds that it knew or should have

known was false.[9] Underwriters could also potentially be liable for misstatements under wire fraud statutes or under state laws. Because this is an area already well regulated under other regulatory schemes and by other regulators, it does not need additional regulation by the MSRB, and the MSRB should revise the Proposal to remove this obligation.

If the MSRB determines to maintain this interpretation, it should clarify how it believes an underwriter must determine that it has a reasonable basis for providing representations and material information in a certificate. Specifically, the MSRB should confirm that an underwriter would meet its "reasonable basis" obligation where it verifies the information in the certificate against the official books of the underwriter and any other factual information within the underwriter's control.

### B. Underwriter's Obligations with Respect to Official Statements.

The Proposal would require, as part of an underwriter's duty of fair dealing to municipal entity issuers, that the underwriter have "a reasonable basis for the representations it makes, and other material information it provides ... in connection with the preparation by the issuer of its disclosure documents." SIFMA believes that this requirement is unreasonably broad and open-ended.

As is current practice, the MSRB should permit an underwriter to agree with an issuer that the underwriter will only be responsible for materials furnished to an issuer if the underwriter has (i) consented, in writing, to such materials being used in offering documents and (ii) agreed with the issuer that the underwriter and not the issuer will assume responsibility for the accuracy and proper presentation of such material. Otherwise, an underwriter would be reluctant to provide financial analysis that may be useful to the issuer (such as providing cash flows based upon various hypothetical assumptions) even if the underwriter has not assumed responsibility for (and the issuer has not assumed the cost of) detailed verification by the underwriter of the assumptions or facts.

The MSRB should also clarify that an underwriter may limit its responsibility for information provided by disclosing to the issuer any limitations on the scope of its analysis and factual verification it performed. In addition, any

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[9] *See, e.g.*, Office of Chief Counsel, Internal Revenue Service, Memorandum No. 200610018, *Application of Section 6700 Penalty with Respect to Various Participants in Tax-Exempt Bond Issuance* (Feb. 3, 2006), *available at* http://www.irs.gov/pub/irs-wd/0610018.pdf.

duty should extend only to *material* information provided by the underwriter and not to all information and analysis.

### C. Fair Pricing.

The Proposal would interpret an underwriter's duty of fair dealing to include an "implied representation" that the price the underwriter paid to an issuer "bears a reasonable relationship to the prevailing market price of the securities."

The MSRB should not interpret as part of an underwriter's duty of fair dealing an "implied representation" that the price an underwriter pays to an issuer bears a reasonable relationship to the prevailing market price of the securities. In a negotiated underwriting, the underwriter should only be required to purchase securities at the price it and the municipal entity issuer negotiated and agreed upon in good faith. Moreover, in many cases underwriters already provide a representation as to the fair market price in its tax certificate, an additional implied representation regarding the "prevailing market price" is unnecessary.

The MSRB's proposed "prevailing market price" standard is also entirely subjective and subject to hindsight bias. In the case of new issue securities, particularly where there is no existing market for the securities being underwritten, there is no "prevailing market" for the securities so there is no way for an underwriter to assure that it can comply with this obligation. The standard would impose a paralyzing evidentiary burden on an underwriter by requiring is to show that an issue price had a "reasonable relationship" to an as-of-yet non-existent prevailing market price. This would require an underwriter to foresee the future, or be forced to negotiate against itself to be sure it is not later questioned for having underpriced the securities.

Further, because municipal issuers have unique credit and risk characteristics, this standard would effectively reinforce the use of credit ratings as a proxy for credit analysis in determining the comparability of different securities issues, which is contrary to the direction of the Dodd-Frank Act and SEC policy guidance.[10]

### D. Profit-Sharing Arrangements.

The Proposal would interpret, as a violation of an underwriter's duty of fair dealing, an arrangement under which an underwriter shares in an investor's

[10] *See, e.g.*, Dodd-Frank Act § 931 (Congressional findings).

profits earned on the resale of the securities, "depending on the facts and circumstances."

The MSRB should provide further guidance as to when profit-sharing with investors would, "depending on the facts and circumstances," constitute a violation of MSRB Rule G-17. The interpretive notice provides almost no guidance as to examples of the type of behavior the MSRB is intending to address with this prohibition, or what "facts and circumstances" would result in a violation.

**E. Retail Order Period Compliance.**

The Proposal would interpret an underwriter's duty of fair dealing to include an obligation to honor any agreement with an issuer as to retail order period directions, unless it receives the issuer's consent to deviate from the issuer's requirements. Particularly, the Proposal would require an underwriter "to take reasonable measures to ensure that retail clients are *bona fide*."

The MSRB should clarify that a dealer's obligations with respect to retail order periods and *bona fide* retail customers will be measured by at least a reasonableness test, and that a dealer will not be strictly liable for violating the issuer's retail order periods unless, under the facts and circumstances, it should have known that the order did not qualify as a "retail order." To this end, the MSRB should confirm that a representation from co-managers in the Agreement Among Underwriters to the effect that retail orders of co-managers are *bona fide* should sufficiently demonstrate that the senior manager took reasonable measures to verify *bona fide* retail orders for syndicate offerings.

**F. Dealer Payments to Issuer Personnel.**

The Proposal "reminds" dealers of their obligations under Rule G-20 with respect to gifts, gratuities and other payments to personnel of an issuer.

The MSRB should confirm that the Proposal does not imply any new obligations or introduce any new interpretations of a dealer's existing obligations under Rule G-20 and serves only as a "reminder." If this is not the case, the MSRB should instead include any guidance it proposes concerning business entertainment, gifts and pay-to-play rules in a substantive proposal or interpretation under Rule G-20, rather than as vague references in the Proposal.

**V. Implementation Period.**

The Proposal would obligate underwriters to comply with detailed and specific requirements to which they are not currently subject. Many of these requirements, depending on whether they are adopted as proposed, will require significant lead time in order for underwriters to create systems to ensure compliance. Therefore, SIFMA requests that when final guidance regarding the application of Rule G-17 to underwriters is adopted, the MSRB provides for a reasonable implementation period, which would certainly be no less than one year, before the Proposal becomes effective.

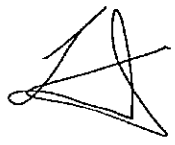
**VI. Conclusion**

SIFMA supports the MSRB in its efforts to provide guidance to underwriters regarding their duties to municipal entity issuers. However, as discussed above, the Proposal should be revised to make clearer distinctions between the fiduciary duties owed by municipal advisors and the more limited duty to deal fairly owed by underwriters. In interpreting this duty, the MSRB should do so in a way that does not duplicate or impose conflicting obligations on underwriters, or create burdens on underwriters that issuers neither want nor benefit from.

* * *

SIFMA appreciates this opportunity to comment upon the MSRB Draft Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities. Please do not hesitate to contact me with any questions at (212) 313-1130; or Robert L.D. Colby and Lanny A. Schwartz, of Davis Polk & Wardwell LLP, at (202) 962-7121 and (212) 450-4174, respectively.

Sincerely yours,



Leslie M. Norwood
Managing Director and
Associate General Counsel

cc: ***Securities and Exchange Commission***
The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
Robert Cook, Director, Division of Trading and Markets
James Brigagliano, Deputy Director, Division of Trading and Markets
David Shillman, Associate Director, Division of Trading and Markets
Martha Haines, Assistant Director and Chief, Office of Municipal Securities
Victoria Crane, Assistant Director, Office of Market Supervision

***Municipal Securities Rulemaking Board***
Lynnette Kelly Hotchkiss, Executive Director
Ernesto Lanza, Deputy Executive Director and General Counsel
Peg Henry, Deputy General Counsel
Karen Du Brul, Associate General Counsel