

MSRB Rule G-17: New Disclosure Requirements Regarding Underwriters' Duties to Municipal Issuers

The Securities and Exchange Commission recently approved the Municipal Securities Rulemaking Board's proposed interpretative notice (the "Notice") on the obligations of underwriters to municipal securities issuers under the fair dealing and anti-fraud provisions of MSRB Rule G-17. The Notice establishes a comprehensive code of conduct for underwriters in their dealings with municipal entities and imposes detailed disclosure obligations relating to the underwriter's role, compensation, and conflicts of interest, as well as the risks associated with complex municipal securities financings. The Notice takes effect on August 2, 2012.

Background

Rule G-17 is one of the MSRB's longstanding rules governing the practices of municipal securities dealers, requiring them to deal fairly with all persons and prohibiting deceptive, dishonest, and unfair practices. Previous interpretative guidance under Rule G-17 focused primarily on the duties of municipal securities dealers to investors. The Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the MSRB's mission to also include the protection of issuers of municipal securities. As of August 2, 2012, the Notice will apply the fair dealing and anti-fraud obligations of underwriters under Rule G-17 to their relationships with state and local governments.

Summary of the Notice

One of the primary goals of the Notice is to help municipal issuers assess proposed financial transactions by requiring the disclosure of important information. The Notice only applies to negotiated underwritings, except where a competitive underwriting is specifically mentioned.

Under the Notice, an underwriter of municipal securities must make the following three types of disclosures to issuers of municipal securities.

1. Disclosures concerning the underwriter's role. The underwriter must disclose the nature of its relationship with the municipal issuer. The underwriter has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable. The underwriter must also disclose that it has a responsibility to investors under the federal securities laws to review the official statement as applied to the facts and circumstances of the transaction.
2. Disclosures concerning material conflicts of interest. The underwriter must disclose whether its underwriting compensation will be contingent on the transaction closing. The underwriter is also required to disclose certain conflicts of interest, including payments to or from third parties, profit-sharing with investors, credit default swaps, and any incentives received by the underwriter to recommend a complex municipal securities financing structure.
3. Disclosures concerning material financial terms and risks of transactions. Even for routine transactions, the underwriter must provide disclosures on material

aspects of the transaction if the issuer's personnel lacks knowledge or experience with the financial structure. For complex financings, such as a variable-rate demand obligation with a swap, the underwriter must disclose material financial characteristics and material financial risks of the financing that are known or foreseeable.

Timing and Manner of Disclosures

The Notice indicates when such disclosures must be made and the form such disclosures must take. The disclosures must be made in writing to an official of the municipal issuer that the underwriter believes (i) has the authority to bind the issuer by contract with the underwriter, (ii) is not party to a disclosed conflict, and (iii) is capable of independently evaluating the disclosures.

Disclosures related to the nature of the underwriter-issuer relationship must occur in the earliest stages of the relationship, for example, in response to a request for proposal or in promotional materials provided to an issuer. Disclosures relating to compensation, the underwriter's role and known conflicts must occur when the engagement begins, not when a purchase contract is entered into. Disclosure of other conflicts will be made as they arise; for example, when a financing structure is agreed upon but before it is executed. These timeframes are meant to ensure that the issuer has the required information before making certain key decisions on the financing.

What to Expect

In order to comply with the new disclosures required by the Notice, the underwriter will provide written materials to the municipal official which disclose the underwriter's role, compensation, actual or potential conflicts of interest, and the risks associated with the transaction. The underwriter will then ask the municipal official to provide written acknowledgment of the receipt of such disclosures. This acknowledgment will likely become a standard feature of underwriters' engagement letters and bond purchase contracts.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact any attorney in Chapman's Public Finance Department or visit us online at chapman.com.

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