Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS MAY 14, 2012

SEC Approves Interpretive Guidance on Underwriters' Duties to Municipal Issuers

On May 4, 2012, the Securities and Exchange Commission approved the Municipal Securities Rulemaking Board's proposed interpretative guidance on the obligations of underwriters to municipal securities issuers under the fair dealing and anti-fraud provisions of MSRB Rule G-17. The guidance 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 guidance also addresses underwriters' representations to issuers, review of official statements, and compensation, as well as fair pricing retail order periods. The guidance will be effective on August 2, 2012.

Background

Rule G-17 is one of the MSRB's longstanding rules governing the practices of municipal securities dealers and requires them to deal fairly with all persons and also prohibits deceptive, dishonest, and unfair practices. The existing 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, and the new interpretative guidance applies the fair dealing and anti-fraud provisions of Rule G-17 to municipal securities dealers serving as underwriters for municipal entities.

The MSRB originally published draft guidance for comment in February 2011 and filed proposed guidance for approval by the SEC in August 2011. In November 2011, the MSRB filed an amendment to the proposed guidance that added disclosure requirements regarding the underwriter's role, compensation, and conflicts of interest. For additional information on these 2011 filings, please see our August 9 and November 15, 2011, Client Alerts, which can be accessed here and here. The SEC approved the MSRB's proposed guidance as amended.

Summary of the Guidance

The guidance as approved clarifies that the notice only applies to negotiated underwritings, except where a competitive underwriting is specifically mentioned.

The disclosure from the underwriter to the municipal issuer must contain the following statements:

- Rule G-17 requires an underwriter to deal fairly at all times with both municipal issuers and investors.
- The underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer.
- Unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests.
- 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 will review the official statement for the issuer's securities in accordance with, and as part of, its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction.

The guidance prohibits an underwriter from recommending that an issuer not retain a financial advisor.

In addition to the above, the underwriter must also disclose whether its compensation is contingent on the closing of the transaction, and, if so, that such contingent payment presents a conflict of interest because it may cause the underwriter to unnecessarily increase the size of the transaction.

The underwriter is also required to disclose items relating to 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.

Timing and Manner of Disclosures

The guidance also indicates when such disclosures must be made and the form such disclosures must take. The disclosures should 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.

The arm's-length transaction disclosure 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 should occur when the engagement begins, not when a purchase contract is entered into. Disclosure of other conflicts should be made as they arise; for example, when a financing structure is agreed upon but before it is executed.

In response to industry comments, the final guidance includes a footnote that states:

> "The various timeframes [for making the required disclosures] are not intended to establish hair-trigger tripwires resulting in numerous but meaningless rule violations so long as underwriters act in substantial compliance with such timeframes and have met the key objectives of the Notice in these regards, being that an issuer has clarity throughout all substantive stages of a financing regarding the roles of its professionals, the issuer is aware of conflicts of interest well before it effectively becomes fully committed (either formally or due to having already expended substantial time and effort) to completing the transaction with such underwriter, and the issuer has the information required to be disclosed with sufficient time to take such information into consideration before making certain key decisions on the financing."

The underwriter should attempt to obtain from the municipal official to whom the disclosures were made a written acknowledgment of the receipt of such disclosures, or in the absence of such written acknowledgment, document that such written acknowledgement was not received. It can be expected that this acknowledgment will become a standard feature of bond purchase contracts.

A Footnote on Financial Advisors and Private Placements

In an interesting twist, the final guidance touches on a matter that has been of significant interest to financial advisors for the past several months. In its comments to the SEC, SIFMA requested clarification that the proposed guidance did not apply to private placement agents. The final guidance includes a footnote that reads as follows:

> "In the case of certain true private placements in which a broker, dealer, or municipal securities dealer ("dealer") is representing an issuer in a fiduciary capacity, certain of these disclosures (such as a description of the dealer's relationship with the issuer as arm's-length, the lack of a fiduciary standard, and the review of the official statement if no such document will be prepared) may be inapplicable and, if so, not required."

In Notice 2011-37 (August 3, 2011), the MSRB noted that the activities of financial advisors in connection with private placements and direct purchase transactions could cause them to be viewed as "brokers" that were required to register as such with the SEC and the MSRB. In a comment that caused considerable consternation in the financial advisory community, the MSRB went on to state:

> "Importantly, financial advisors that have not traditionally viewed themselves as brokers could unintentionally become subject to MSRB Rule G-23, which, effective November 27, 2011, generally precludes financial advisors that are broker-dealers from becoming underwriters or placement agents for issues of municipal securities for which they have been serving as financial advisors."

The footnote in the final guidance indicates that the SEC and MSRB recognize that a broker-dealer may represent an issuer in a fiduciary capacity in connection with a private placement. While this is consistent with the definition of "municipal advisor" in the Dodd-Frank Act (which includes "placement agents" in addition to financial and other advisors), it is not consistent with the present text of Rule G-23(d) and positions previously taken by MSRB staff and counsel, both of which equate placement agent activities with underwriting activities. While not directly addressed, the final guidance suggests that a financial advisor may not run afoul of the prohibitions of Rule G-23 if it simultaneously acts as the issuer's agent in a true private placement. From a principled perspective, there does not appear to be any inherent conflict when the financial advisor and placement agent functions are being performed by a single agent with fiduciary duties to the issuer. To address this point, clarifying amendments to Rule G-23 and Notice 2011-37 would appear to be in order.

What the final guidance doesn't provide is a definition of what is a "true" private placement for purposes of Rules G-17 and G-23. The MSRB's position on this is set out in its December 7, 2011, response to the comments filed on the guidance:

> "Dealers must remain cognizant of the fact that the circumstances under which a true private placement may arise in the municipal market are quite constrained, and dealers are cautioned against casually relying upon common characterizations of new issue municipal offerings as private placements since many if not most of such transactions may not be true private placements. *In particular, a private placement, for purposes of this paragraph, must involve a situation where the dealer has taken on a true agency role with the issuer (which at a minimum negates any arm's-length aspect of the relationship and would normally give rise to state law fiduciary obligations owed to the issuer and where the dealer does not take any principal position (including any so-called "riskless principal" position) in the securities.* The fact that an offering qualifies for the exemption from the Commission's Rule 15c2-12 under paragraph (d)(1)(i) thereof, or that the securities are offered only in large denominations, or are only offered to sophisticated municipal market professionals or other classes of institutional investors, does not by itself determine whether an offering is a private placement." [emphasis added]

As you know, this Client Alert is not intended to constitute legal advice and a municipal advisor that is considering simultaneously serving as a placement agent should consult experienced municipal securities counsel.

What's Next?

We are expecting that the next several months will see significant developments in the municipal securities arena, some of which could be game-changers. The Government Accountability Office's report on municipal securities disclosure practices and the continuing viability of the Tower Amendment is due by the second anniversary of the enactment of the Dodd-Frank Act this July. The SEC Staff Report on Commissioner Walter's field hearings on the municipal securities market is expected to include a focus on disclosure practices and could include a call for legislation and/or additional SEC regulation, as well as interpretative guidance by the SEC Staff.

The SEC's temporary registration regulations for municipal advisors are scheduled to expire on September 30. While it is possible that the temporary regulations could be extended again, it is expected that the SEC will seek to issue final registration regulations well in advance of September 30. In recent testimony before the House Financial Services Committee, SEC Chair Shapiro indicated that the final regulations would narrow the scope of the municipal advisor definition contained in the proposed regulation.

Last, but certainly not least, the MSRB's suspended municipal advisor rulemaking process will restart once the final municipal advisor registration regulations are issued. It is hoped that the MSRB will republish these rules for industry comment before they are filed with the SEC for approval. The scope and tenor of the Rule G-17 interpretative guidance described in this Client Alert strongly suggests that the municipal advisor community can expect comparable code of conduct rules with specific requirements and prescriptions.

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.