

# Client Alert

Current Issues Relevant to Our Clients

January 15, 2014

## Municipal Securities Rulemaking Board Proposes Rule G-42 on the Duties of Municipal Advisors

On January 9, 2014, the Municipal Securities Rulemaking Board (MSRB) proposed Rule G-42, defining the fiduciary duties of municipal advisors to municipal entity clients and the duties and responsibilities owed to all municipal advisory clients. The Proposed Rule would establish a comprehensive code of conduct for municipal advisors, and also prohibits most transactions between a municipal advisor or its affiliates, acting as principal, and its municipal advisory clients. The Proposed Rule, if adopted as proposed, can be expected to significantly impact the relationships and course of dealings between municipal advisors and their clients. The Proposed Rule does not apply to municipal advisors undertaking solicitations of municipal entities and obligated persons.

The Proposed Rule and the MSRB's related Regulatory Notice 2014-01 can be found [here](#).

### Background

Under Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a person that provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities is a "municipal advisor" and is required to register with the SEC and the MSRB. In addition to the registration requirement, municipal advisors are:

- subject to substantially the same disciplinary rules of the SEC as municipal securities dealers, as well as MSRB rulemakings with respect to training and competence, standards of conduct, record keeping and other matters,
- subject to a broad anti-fraud prohibition in connection with issuances of municipal securities, municipal financial products and solicitations of municipal entities and obligated persons,
- subject to a fiduciary duty to their municipal entity clients, and
- prohibited from engaging in any act, practice, or course of business which is not consistent with a municipal advisor's fiduciary duty or that contravenes any rule of the MSRB.

The SEC's temporary registration regime for municipal advisors became effective on October 1, 2010.

The SEC issued proposed rules for the registration of municipal advisors in late 2010. After a lengthy process that included significant public comment, the SEC approved final registration rules on September 18, 2013. The registration rules were scheduled to become effective on January 13, 2014, but the SEC has issued a stay of these rules until July 1, 2014. Our Client Alert on the SEC's recent guidance for the registration rules can be found [here](#).

Following on the SEC's proposed registration rules for municipal advisors, the MSRB began its municipal advisor rulemaking process in the first quarter of 2011, and issued various proposed rules, including proposed Rule G-36 on the fiduciary duty of municipal advisors. After public comment, the MSRB filed modified rules with the SEC for approval, but subsequently withdrew them pending the completion of the SEC's municipal advisor registration rulemaking process.

Proposed Rule G-42 is similar in many respects to the proposed Rule G-36 rulemaking, but also includes a number of revisions and additions to the original proposal.

## The Fiduciary Duty: A Duty of Care and A Duty of Loyalty

While the Dodd-Frank Act imposed a fiduciary duty on advisors to municipal entities<sup>1</sup>, neither it nor the SEC's municipal advisor registration rules define the scope of the fiduciary duty. The Proposed Rule defines the fiduciary duty as including a duty of care and a duty of loyalty, and includes non-exclusive lists and descriptions of a municipal advisor's obligations under these duties.

The proposed **duty of care** applies to both municipal entity and obligated person<sup>2</sup> clients, and requires that a municipal advisor:

- exercise *due care* in performing municipal advisory activities,
- possess the *degree of knowledge and expertise* needed to provide the client with informed advice,
- make a *reasonable inquiry* as to the facts that are relevant to a client's determination as to whether to proceed with a course of action or that form the basis for any advice provided to the client,
- undertake a *reasonable investigation* to determine that the municipal advisor is not basing any recommendation on materially inaccurate or incomplete information,
- for engagements involving the issuance of municipal securities or a municipal financial product that is related to an issuance of municipal securities, undertake a *thorough review of the official statement* unless otherwise directed by the client and documented in writing, and
- have a *reasonable basis* for any advice provided, any representations made in certificates it signs that will be relied upon by the client, other parties or investors, and any information provided to the

<sup>1</sup> Under the SEC's municipal advisor registration rules, a "municipal entity" includes States, political subdivisions of a State, and municipal corporate instrumentalities of a State or a political subdivision, and also includes public employee retirement systems and benefit plans, and local government investment pools.

<sup>2</sup> Under the SEC's municipal advisor registration rules, "obligated person" has the same meaning as in Rule 15c2-12. In most cases, an obligated person will be a borrower under a conduit bond issue by a municipal entity. The SEC's definition of obligated person excludes (a) providers of credit enhancement and liquidity facilities, (b) persons whose financial information or operating data is not material to a municipal securities offering and (c) the federal government.

client or other parties when participating in the preparation of an official statement

The Proposed Rule provides little in the way of guidance on the scope of these responsibilities, though it is likely that they will be shaped with reference to comparable concepts in other areas of federal securities regulation.

The proposed **duty of loyalty**, which applies to a municipal entity client but not an obligated person client, requires that a municipal advisor:

- deal honestly and *with the utmost good faith* with a municipal entity client,
- act in the client's best interests *without regard to the financial or other interest of the municipal advisor*,
- eliminate or provide *full and fair disclosure of all material conflicts*, and
- *consider other alternatives* to any recommended municipal securities transaction or municipal financial product that might serve the client's objectives.

The above lists of requirements under the duty of care and the duty of loyalty are not exclusive.

Notably, the MSRB requested comment on whether the fiduciary duty should be extended to all clients of a municipal advisor, including obligated persons. This would have the effect, among other things, of extending the duty of loyalty to obligated person clients.

### Standards of Conduct for Municipal Advisors

In addition to the duties of loyalty and care, the Proposed Rule sets forth a *detailed code of conduct* owed by municipal advisors to all of their clients. Below are the highlights of the additional responsibilities of municipal advisors under the Proposed Rule.

**Principal Transactions Prohibited.** The Proposed Rule includes a comprehensive and non-waivable prohibition on *any principal transaction* between a municipal advisor (or an affiliate of a municipal advisor) and a client, except for the limited transactions permitted by MSRB Rule G-23. The proposed prohibition applies to all transactions, not just those transactions that are related to a municipal advisor's engagement by a municipal entity or obligated person. The MSRB stated that principal transactions are a particular area of regulatory concern because of the "high potential for self-dealing." The proposed prohibition raises significant issues for financial institutions that have municipal advisor affiliates.

**Review of Official Statements.** The duty of care under the Proposed Rule includes an automatic requirement for a municipal advisor to undertake a “thorough review” of the official statement or similar disclosure document. The municipal advisor cannot disclaim or limit this requirement, but its client can agree to exclude, limit or alter the requirement. Any exclusion or limitation must be set forth in the writing evidencing the municipal advisor relationship (discussed below).

The client and advisor may also agree upon other responsibilities of the advisor with respect to the official statement, which would have to be set forth in the writing evidencing the municipal advisor relationship. The MSRB believes this requirement may encourage the client to consider at the outset of the transaction whether and to what extent the client wants the municipal advisor as well as other persons (*e.g.*, bond or disclosure counsel) to assume responsibilities with regard to the official statement.

The proposed “thorough review” requirement for official statements should be considered carefully by municipal advisors and their clients. The MSRB requested comment on this requirement, including whether a municipal advisor should be permitted to disclaim it.

**Disclosure of Affiliations.** If a municipal advisor or its affiliate prepares a document that is included in an official statement, the affiliation and the advice, service or product provided by the affiliate must be disclosed in writing to investors. This disclosure may be made in the official statement.

**Reasonable Basis for Recommendations; Suitability.** Under the Proposed Rule, a municipal advisor may recommend a municipal securities transaction or municipal financial product only if it has a reasonable basis for believing that the transaction or product is suitable for the client and in the client’s best interest. The advisor would be required to exercise reasonable diligence to obtain the information necessary to make a recommendation. The factors that need to be considered by an advisor under the suitability standard include its client’s :

- general experience with transactions in municipal securities and municipal financial products, and the client’s specific experience with securities and products of the type and complexity being recommended,
- financial situation, needs and objectives, and
- risk tolerance, liquidity needs and financial capacity to withstand changes in market conditions during the term of a proposed transaction

The MSRB requested comment on whether an advisor’s suitability obligation should include review any feasibility study provided to its client.

The advisor must discuss certain matters with the client, including the advisor’s basis for a recommendation and whether it has considered other alternatives. There is also a “Know Your Client” obligation that requires a municipal advisor to know and maintain essential facts concerning its client and in support of the advisor’s suitability obligations.

**Disclosure of Conflicts, Other Information.** The Proposed Rule includes a list of conflicts and other items the municipal advisor must fully and fairly disclose to its client in writing at or before the municipal advisory relationship begins. The municipal advisory relationship is deemed to exist when a municipal advisor engages in municipal advisory activities for a client. It is not necessary to have an engagement letter for the relationship to exist.

The conflicts of interest that require disclosure include other engagements or relationships of the advisor or any affiliate that might impair the advisor’s ability to render unbiased and competent advice or to fulfill its fiduciary duty. Municipal advisors must also disclose legal and disciplinary events that are material to a client’s evaluation of the advisor or that are disclosed on municipal advisor registration forms.

Additionally, municipal advisors must disclose any conflicts of interest that may arise from the form of compensation for the municipal advisory activities to be performed. While this requirement is narrower than what was originally proposed by the MSRB in 2011, it still appears to require municipal advisors to provide conflicts disclosure regardless of the form of compensation involved. The MSRB requested comment on disclosure of conflicts that may arise from the form of compensation.

The Proposed Rule also requires municipal advisors to disclose the amount and scope of coverage of their professional liability insurance, including deductible amounts and any material limitations on coverage, or a statement that the advisor does not carry any coverage. The MSRB requested comment on whether municipal advisors should be required to carry professional liability insurance, including minimum amounts and terms of coverage.

The Proposed Rule requires municipal advisors to include an explanation of how the advisor will manage or mitigate each conflict of interest. The Proposed Rule does not require that the municipal advisor obtain the client’s acknowledgement or consent to conflicts, although the MSRB requested comment on this point.

**Documentation of Municipal Advisory Relationship.**

The Proposed Rule requires a municipal advisor to document a municipal advisory relationship in writing prior to, upon or promptly after the beginning of the relationship. The writing will typically be in the form of a financial advisory agreement, but it does not necessarily have to be signed by the client (*i.e.*, an exchange of e-mails could provide the necessary writing). In either case, the agreement between an advisor and its client must include matters relating to compensation, the scope and limitations of the municipal advisory activities to be performed, conflicts and terms for termination. The agreement must include the parties' agreement as to the municipal advisor's responsibilities with regard to the official statement.

A municipal advisor must update a financial advisory agreement to reflect material changes in or additions to the required conflict of interest disclosures or the terms of the engagement. An advisor would violate the Proposed Rule if it should have discovered such changes or additions in the exercise of reasonable diligence and fails to update the agreement.

**Review of Third-Party Recommendations.** The Proposed Rule requires a municipal advisor to undertake a "thorough review" of a third party's recommendation regarding a municipal securities transaction or municipal financial product, if the client requests and it would be within the scope of the engagement. The municipal advisor must discuss with the client whether the advisor believes the recommended transaction or product is suitable for the client and the basis for such belief, as well as whether the advisor has considered alternatives and other matters.

**Specified Prohibitions.** The Proposed Rule prohibits municipal advisors from engaging in certain activities, including receiving excessive compensation, delivering invoices that do not accurately reflect activities performed or personnel that performed services and making materially false or misleading representations in RFPs or RFQs or in oral presentations. Fee-splitting arrangements with underwriters are prohibited. Any undisclosed fee-splitting arrangements with the client's investment or service providers would be prohibited. Municipal advisors would also be barred from making payments to obtain or retain municipal advisory business, other than reasonable fees paid to another advisor that solicits business and is properly registered.

**Record-Keeping.** In connection with the Proposed Rule, the MSRB also proposes to amend Rules G-8 and G-9 regarding record keeping. The proposed amendments incorporate all of the record-keeping requirements of the SEC's municipal advisor registration rules and include additional record-keeping in light of the requirements of the Proposed Rule (*e.g.*, documents relating to an advisor's review of a third-party recommendation). The

proposed amendments to Rules G-8 and G-9 also include requirements regarding the length of time for keeping records and related matters.

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## Next Steps

The MSRB will host a webinar on the Proposed Rule on February 6, 2014 at 3:00 p.m., Eastern Time. Registration information is available through the MSRB's website [here](#).

Comments on the Proposed Rule must be submitted by March 10, 2014.

The Proposed Rule is the first of several municipal advisor rules that will be issued by the MSRB in the coming months. All of these proposed rules will be public subject to public comment.

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## For More Information

*Please contact your primary attorney at Chapman and Cutler if you have any questions on the Proposed Rule or would like our assistance in preparing comments.*

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