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Underwriter's Duty to Deal Fairly With Municipal Issuers

SEC Approves MSRB Interpretive Notice Addressing Rule G-17 to Underwriter-Municipal Issuer Relationships; MSRB to Host Webinar on the Topic June 27, 2012

Last month, the Securities and Exchange Commission approved the Municipal Securities Rulemaking Board's (MSRB) interpretive notice (Notice) explaining an underwriter's duty of fair dealing to municipal issuers under MSRB Rule G-17[1]. The Notice will become effective on August 2, 2012, and except where a competitive underwriting is mentioned, applies only to negotiated underwritings.

Under the Notice, Rule G-17 requires an underwriter to make specific disclosures to its state and local government issuer clients regarding compensation, conflicts of interest and third-party relationships, as well as the fact that the underwriter owes no federal fiduciary duty to such issuer. Additionally, if the underwriter is recommending a complex financing structure, the MSRB interprets Rule G-17 to require an underwriter to disclose "all the material risks and financial characteristics of the complex municipal securities financing, as well as the material financial risks of the financing that are known to the underwriter and reasonably foreseeable at the time of the disclosure."

The text of MSRB Rule G-17 is short and simple: "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." The MSRB has previously stated this duty of fair dealing extends to the interactions between a municipal underwriter and a municipal issuer; however, the Dodd-Frank Act[2] now specifically directs the MSRB to protect municipal issuers. The Notice lays out in detail how the MSRB expects municipal underwriters to comply with Rule G-17 when acting as an underwriter in a municipal securities transaction.

Some of the key interpretations included in the Notice are:

- Rule G-17 does not merely prohibit fraud and deception on the part of an underwriter; it also establishes a general duty of a municipal underwriter to deal fairly with all persons, including municipal issuers, even in the absence of fraud.
- The duty to deal fairly includes a duty to disclose the nature of the underwriter's role in the transaction, and that it has financial and other interests that differ from those of the issuer.
- Unlike a municipal advisor, the underwriter is not required by federal law to act in the best interest of the issuer.
- The underwriter must not recommend that the issuer refrain from retaining a municipal advisor.

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[1] See Securities and Exchange Commission Release No. 34-34-66927 (May 4, 2012) and MSRB Notice 2012-25 (May 7, 2012).

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

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- The underwriter must also disclose whether the underwriter's compensation is contingent on the closing of a transaction, and that compensation contingent on the closing or size of a transaction presents a conflict of interest.
- An underwriter must disclose to the issuer the existence of payments, values or credits received or made by the underwriter from third parties that relate directly or indirectly to collateral transactions integrally related to the issue being underwritten.
- Arrangements between the underwriter and an investor purchasing new issue securities from the underwriter under 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, constitute a violation of the underwriter's fair dealing obligation under Rule G-17.
- The issuance or purchase by a dealer of credit default swaps relating to the issuer's securities may pose a conflict of interest, because trading in such municipal credit default swaps has the potential to affect the pricing of the underlying obligations, as well as the pricing of other obligations brought to market by that issuer. A dealer must therefore disclose the fact that it engages in such activities to the issuers for which it serves as underwriter.
- Underwriters should consider whether payment of expenses of issuer personnel in the course of the bond issuance process, including, for example, rating agency trip expenses – are not so lavish and excessive as to violate MSRB rules (such as Rule G-20, which restricts gifts and gratuities).

Regarding the disclosure associated with complex financing structures, the MSRB interprets Rule G-17 as requiring an underwriter to make more in depth disclosures than those that may be made with respect to routine financing structures. The MSRB cites variable rate demand obligations (VRDOs) and financings involving interest rate swaps or other derivatives as examples of complex municipal securities financings. In addition to disclosing any material financial risks and characteristics of the complex financing structure, the underwriter must disclose any incentives for the underwriter to recommend the financing and other associated conflicts of interest. Under the Notice, these disclosures regarding complex municipal financing structures must be in writing and provided sufficiently in advance of the sale of the securities to allow the issuer to evaluate the recommendation. The disclosures concerning a complex municipal securities financing may not be general in nature and should be made to an issuer official whom the underwriter reasonably believes "is capable of independently evaluating the disclosures." If the underwriter does not reasonably believe the official is capable of independently evaluating the disclosure, the underwriter is required to make "additional efforts reasonably designed to inform the official or its employees or agent."

The timing and form of the disclosures depend upon the particular disclosure required. For example, disclosure regarding the role of the underwriter in the transaction should be made when the underwriter is engaged to perform underwriting services (e.g., in an engagement letter), not solely in a bond purchase agreement. The underwriter must also attempt to receive written acknowledgement (other than by automatic email receipt) by the official of the issuer of receipt of the disclosures.

The Notice is an interpretation of an existing MSRB rule, so it should not, at least theoretically, result in material change in the relationship between the underwriter and the municipal issuer. It may, however, clarify the nature of the relationship and provide a required procedure intended to facilitate the municipal issuer's understanding of that relationship. The MSRB announced it will host an educational webinar on June 27, 2012 at 1 p.m. EDT. Although the presentation will be geared toward municipal bond dealers, all market participants are welcome. Registration is free. You may view the MSRB Notice and Rule G-17, as well as register for the webinar at www.msrb.org.

If you would like to talk to one of our public finance lawyers regarding the Notice, or any other matter, please contact the Squire Sanders lawyer with whom you usually work.

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