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MSRB Notice Details MA Conduct Requirements; Webinar Planned.

WASHINGTON – The Municipal Securities Rulemaking Board on Tuesday released a regulatory notice detailing new core conduct requirements for municipal advisors.

The MSRB also plans to hold a webinar to discuss Rule G-42's requirements on April 28 before they are implemented in June.

Rule G-42 was approved by the Securities and Exchange Commission on Dec. 23. The MSRB first proposed Rule G-42 in January 2014 and, after making several changes, filed it with the SEC for approval in April 2015. The SEC twice extended the time to consider the rule and the MSRB filed two amendments — one tightening and clarifying language contained in the rule and the second allowing for a limited exception to a controversial principal transaction ban for MAs.

A central portion of the rule defines the fiduciary duty MAs owe their clients to include both a "duty of care" and a "duty of loyalty."

The duty of loyalty is owed to an MA's municipal issuer clients and requires the advisor "without limitation … to deal honestly and with the upmost good faith with a municipal entity and act in the client's best interests without regard to [its] financial or other interests." The duty prevents an MA from engaging with municipal issuer clients if the MA cannot manage or prevent conflicts of interest.

The duty of care is owed to all clients and requires MAs to: exercise due care in their work; be qualified to provide advisor services; make a "reasonable inquiry" into the facts relevant to a client's request before deciding whether to proceed; and undertake a "reasonable investigation" to determine their advice is not based on bad information.

Whether providing direct advice to a client or reviewing a third party's recommendation to a client, the MA has to show that it has a reasonable basis for the conclusions it shares with its client. To fulfill the obligation, the MA must tell its client about: the evaluation of material risks, potential benefits, structure and other characteristics of the recommended muni transaction or financial product; the basis for the advisor's belief that the transaction or product is suitable for the client; and whether the MA has investigated or considered other alternatives for the client. The MA must take into account such things as the client's financial situation and needs, objectives, tax status, risk tolerance, and liquidity needs, according to the notice.

Another part of the rule requires MAs to document their advisory relationships in writing before, at the start, or promptly after the start of their advisory activities with a client. The documentation portion of the rule requires seven pieces of information, including a description of the scope of municipal advisory activities and any conflicts of interest, the disclosure of which is described in a different section of the rule.

The rule does not provide an exhaustive list of reportable conflicts of interest, which must be

reported before or at the start of the relationship, but lays out several examples, including: MA payments to be made to an issuer official to obtain an engagement for services; any advice an affiliate of the MA provides to the client that is directly related to the municipal advisory activities of the MA and; any fee-splitting arrangements involving the MA and a provider of investments or services to the client.

Conflicts of interest that are disclosed in writing must be detailed enough to tell the client the nature, implications, and potential consequences of each conflict and must include an explanation of how the MA plans to address each instance, the MSRB said.

If an MA uses “reasonable diligence” to conclude it does not have any conflicts of interest, it must inform its issuer client or other borrower in writing that it came to that conclusion.

Additionally, if an MA gives advice to a client inadvertently, it does not have to follow the disclosure and documentation requirements. Instead, the MA could give its client a document that includes a disclaimer explaining and identifying the inadvertent advice and stating the MA is no longer giving that client advice. The MA must also review its supervisory procedures to better prevent inadvertent advice in the future.

The rule includes a list of specified prohibitions on MA activity, including excessive compensation in relation to the advice given, inaccurate invoices for advisory work, and false or materially misleading representations of an MA’s expertise. MAs also cannot enter into fee-splitting arrangements with an underwriter on a transaction for which the MA is providing advice or with regard to an undisclosed relationship with an investment or service provider for a municipal entity or obligated person client of the MA.

A final and controversial portion of the rule bans MAs from acting as a principal in a transaction with a muni issuer client that is directly related to a transaction on which the MA is providing advice. The transaction would include any bank loan if its amount exceeds $1 million.

The proposed rule contained an outright ban on principal transactions for most of the time it was considered and drew strong criticism from dealer and issuer groups. They claimed the ban was overly burdensome and would drive up costs for issuers.

Rule G-42 now includes a narrow exception to the ban for registered broker-dealers on sales to, or purchases from, a municipal client of U.S. Treasury securities, agency debt securities, or corporate debt securities. The exception allows MAs to either make written disclosure on a transaction-b--transaction basis and receive the issuer’s written or oral consent or meet several additional procedural requirements so that the MA could make oral rather than written disclosure.

The Bond Buyer

by Jack Casey

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