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Commentary: Duty of Care Enforcement for Municipal Advisors.

The Securities and Exchange Commission this month announced a significant enforcement action against an Oklahoma municipal advisor, Municipal Finance Services, Inc., and two officers of the firm, including its founder and president.

The action, announced on Aug. 24, offers helpful guidance for municipal advisors regarding the fiduciary duty of care. Prior municipal advisor enforcement has focused on disclosure to issuer clients of advisors' conflicts of interest, an important duty of loyalty element. As a whole, these actions reflect the SEC's constructive concerns for issuer protection pursuant to Dodd-Frank.

The SEC summarized: "Fiduciaries must act in the utmost good faith and use reasonable care to avoid misleading clients." Issuers will benefit from advisor competence and affirmative provision of informed advice.

The MFSOK action also illustrates how advisors' professional obligations to issuers can be expected to benefit investors when advisors assist issuers with disclosure. The SEC stated in its 1988 release proposing the Commission's interpretation regarding underwriter investigatory responsibilities that financial advisors "hav[ing] access to issuer data and participat[ing] in drafting the disclosure documents" in competitive sales "will have a comparable obligation [to the investigatory responsibilities of underwriters] under the antifraud provisions to inquire into the completeness and accuracy of disclosure presented during the bidding process."

Some advisors disagreed strongly, but the MFSOK action shows that the Commission is persisting, appropriately using the municipal advisors' fiduciary duty as a vehicle. Since 1988, the SEC also has undertaken disclosure enforcement against financial advisors in negotiated offerings.

MSRB Rule G-42 was not in effect at the time of the MFSOK events beginning in 2011. So, the action is based on the statute. Nevertheless, several important Rule G-42 themes appear in the SEC's release.

At the outset, it is important to consider MFSOK's contracted scope of services with a City. The SEC's release states that, pursuant to a 2011 agreement, MFSOK "was responsible for preparing the City's official statements, … reviewing and commenting on all legal documents" related to bond issuance, and "assisting the City in complying with its continuing disclosure agreements."

The City had entered into continuing disclosure agreements in 2005, 2008 and 2012 requiring audited financial statement filings within 180 days after fiscal year end. In accordance with SEC no-action guidance, the 2005 and 2008 CDAs could be amended only "with (1) bondholder consent; or (2) an opinion of bond counsel that the amendment would not materially impair the interests of bondholders."

The amendment and bond counsel opinion were required to be filed with repositories. The 2012 CDA omitted amendment by bondholder consent, looking to bond counsel or paying agent determinations.

Each CDA required filing of an event notice upon a modification of bondholder rights.

MFSOK assisted the City with competitive sales in 2012 and 2013. In 2013, MFSOK's officers reviewed and commented on a CDA draft. The 2013 CDA, which was "prepared by bond counsel," "purported to" amend the three prior CDAs to extend the City's filing date to 360 days. The Commission concluded that the amendment was adverse to investors because it "had the effect of delaying significantly the date by which investors in the 2005, 2008 and 2012 bonds had access to the City's annual reports." The Commission observed that "some investors in the earlier bonds engaged in transactions without the benefit of the updated financial information … that had been promised … ."

MFSOK's officers had never seen such an amendment and had concerns. Yet, they "did not conduct further investigation and did not seek further information from bond counsel or otherwise attempt to determine whether the amendment complied with the terms of the City's three prior CDAs." The preparation of the 2013 amendment by bond counsel did not equate with the required bond counsel opinion.

Importantly, MFSOK's officers did not communicate their concerns to the City. They "failed to advise their client of the prerequisites for amendments … and failed to ensure that their client was in compliance." Instead, MFSOK "recommended" that the City sell the 2013 bonds to an underwriter in a competitive sale using an official statement that summarized the 2013 CDA. The City executed the 2013 amendment, "relying in part on MFSOK's advice."

Although MFSOK had begun in 2011 to assist the City "with the submission of annual reports on EMMA," MFSOK did not advise the City until 2016 to file the 2013 CDA amendments, with the result that investors holding the prior bonds "were not informed of the new 360-day deadline" for three years.

All Respondents were ordered to cease and desist violations; MFSOK was censured; MFSOK was ordered to pay a $50,000 civil penalty; each of its two officers were ordered to pay $8,000 civil penalties; and MFSOK entered into undertakings to establish written policies and procedures and periodic training "regarding the fiduciary duty" and to appoint an official responsible for ensuring compliance with the policies and procedures and maintenance of records regarding training.

The MFSOK action provides significant food for thought for advisors. It applies the advisors' fiduciary duty of care strictly, but fairly, requiring due care in the provision of advice, the provision of informed advice, and the conduct of due diligence as a basis for recommendations to issuers. MFSOK's investigatory responsibilities to assist the City in making disclosure provides important investor protections.

Of course, every action depends upon specific circumstances. Advisors' responsibilities to issuers depend upon contractual scopes of services. Still, the MFSOK action provides an excellent template. One may expect that, as future actions apply MSRB Rule G-42, with its granular elaboration of advisors' duties, issuers, investors and the market as a whole will benefit from substantially increased professionalism.

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