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Some Dealer Contracts with Issuers Raise Legal, Compliance Questions.

A number of dealer contracts with issuer officials for municipal bond business seem to violate or come close to violating federal standards and a Municipal Securities Rulemaking Board rule that bars the firms from serving as both underwriter and financial advisor in the same transaction.

In these contracts, the firms appear to be engaging in wordplay in an attempt to leave the door open to performing both financial advisory and underwriting services on the same transaction, a practice prohibited by MSRB Rule G-23.

The contracts also appear to muddle the nature of the relationship between the parties. Some state the dealer is providing financial advisory services, but the dealer denies in the contract that it has a financial advisory relationship with the issuer and a fiduciary duty to put the issuer's interests first, possibly violating the Dodd-Frank Wall Street Reform and Consumer Protection Act.

A number of dealers are increasingly saying they are merely providing consulting services or are independent contractors, instead of financial advisory services, even if the contracts say they are being hired as financial advisors.

Earlier this year, the St. Louis Regional Convention and Sports Complex Authority signed a contract with Goldman Sachs & Co. stating the firm was "exclusively engaged … as financial advisor" to help the RSA consider its "various financial alternatives" for renovating or replacing the Edward Jones Dome, home to the National Football League's St. Louis Rams.

Goldman said its analysis of alternatives "may include investments, divestitures, financial restructurings, liability management transactions, loan financings, public or private financings (including, but not limited to, the offering of securities), debt repurchases, joint ventures, or other operations involving the RSA."

Under the Dodd-Frank Act, municipal advisors are "deemed to have a fiduciary duty" to an issuer client, requiring them to put the issuer's best interest first, before their own. The act says muni advisors include financial advisors.

But Goldman said in the contract that it is serving as "an independent contractor with duties solely to the RSA" and that it does not have a fiduciary duty to the RSA.

Dealers and some market participants contend that if a dealer is not providing financial advice with regard to a specific muni bond issue, then it is not serving as a financial advisor and does not have a fiduciary duty to the issuer.

Goldman said in its letter, for example, that it was not providing "advice" as defined by Section 15B of the Securities Exchange Act of 1934, which says advisors provide advice "with respect to municipal financial products or the issuance of municipal securities."

Goldman Sachs declined to address the specifics of the contract.

But a source familiar with the firm's thinking said that no work has been done for the St. Louis Regional Convention and Sports Complex Authority. The source said that although the contract uses the term "financial advisor" Goldman Sachs would be acting in a broad role and that the advice would not cover the issuance of municipal securities.

"That is wrong. That is flat-out wrong," said an attorney familiar with muni securities laws and rules, adding he views this as a possible violation of Dodd-Frank.

Asked if this might be a Dodd-Frank violation, Malcolm Northam, the former head of fixed income regulation at the Financial Industry Regulatory Authority who now has his own consulting firm, said, "That's an interesting question. You say you're doing one thing but in reality you seem to be doing another thing. I think these are fair questions to ask."

"I think they may be trying to disclaim away what they can't disclaim away," he added.

The contract also said Goldman "may to act as an underwriter for an offering of securities in connection with the financing of the renovation or replacement of the stadium," raising the question of whether the firm would have a G-23 problem.

Brian McMurtry, RSA's executive director, said Goldman Sachs' work has not covered the issuance of bonds, and is mostly concerned with "how to protect the taxpayer investment" in the facility as it exists now.

"It's not about new money at this point," McMurtry said.

Mike Nicholas, the chief executive officer of the Bond Dealers of America, said contracts like this one are in compliance with G-23 because they spell out the role of the dealer firm quite clearly and do not relate to any specific bond transactions.

"The contracts are explicit in explaining the services being contracted are not for underwriting services or to provide financial advice on a specific bond issue, Nicholas said. "Rule G-23 is issue-specific, meaning a firm can provide general financial advice and later act as an underwriter on a bond issue for that issuer without it being in violation of G-23."

A muni advisor, who did not want to be identified, said a case like this requires interpretation by the MSRB.

The rule says a financial advisory relationship exists if a firm gives advice "with respect to" an issuance of securities. That can lead some firms to interpret that clause in its broadest possible sense and argue they are not FAs because they are not providing advice on a specific transaction.

"In a theoretical sense, it might be possible to be pure, but it's not very likely," he said.

If a firm is going to give a public entity comprehensive advice about a project, it is hard to see how municipal bonds would not be a part of that and in such a case it would be difficult to claim the advice was not "with respect to" a bond issuance, he added.

"People are attempting to walk a very, very fine line," he said.

SIFMA declined to comment.

A June 26, 2012 contract between Milwaukee-based Robert W. Baird and Co. and the Monroe County Board of Supervisors of Monroe County, Wis., says the county is retaining Baird for "general consulting services" that do "not cover any financial advisory … services that are directly related to any specific financings or offerings."

Despite that disclaimer, Baird agrees to provide, "a possible review of borrowing costs, advice and information on the state of the market for municipal financings, education about possible financing structures and terms [and] information about the offering process."

The contract states that if the issuer decides to issue bonds it "may engage Baird as financial advisor, underwriter, or placement agent with respect to such issuance."

James Kuhn, chair of the Monroe County Finance Committee, said the county has spent more than a decade trying to put together a deal for construction of new facilities to relieve jail overcrowding.

Baird had been contractually involved in a planned 2009 bond deal that fell apart after a newly-elected county board scuttled the agreement, Kuhn said, so when the county sought to put the deal together a second time Baird was first in line.

"They wanted the contract, and I don't blame them," Kuhn said, noting that Baird previously put in a lot of work for no compensation.

Kuhn said that the county tentatively plans to come to market with about $20 million of bonds near the end of the year, and is in discussions with Baird to underwrite the bonds.

Baird declined to comment on the specifics of the contract with Monroe County.

Critics of these arrangements say the whole point of the G-23 prohibition is to do away with an actual conflict of interest.

The concern is that a dealer-FA could recommend a bond deal, structure the deal to its advantage, and then turn around and underwrite the bonds. An FA is supposed to have a fiduciary duty to an issuer client to the put the client's interest first, whereas an underwriter has an arm's length transaction with the issuer, putting its own interests first, ahead of the issuer's.

Rule G-23 initially permitted dealers to serve as FAs and then underwrite bonds in the same deal, if they resigned as FA first and informed the issuer of possible conflicts of interest from the role switch.

Non-dealer FAs tried for years to get the board to prohibit the role-switching, claiming it was a real conflict of interest not a potential one. The National Association of Independent Public Finance Advisors in late 2005 supplied the MSRB with transaction data that it claimed showed dealers in Texas were circumventing Rule G-23. But dealer groups, as well as the Municipal Advisory Council of Texas, claimed the data was misinterpreted.

The MSRB reconsidered G-23 in 2006, but decided there was not enough evidence to justify a prohibition, and stayed the course.

In May 2010, Mary Schapiro, the SEC chairman at the time, urged the MSRB to prohibit dealers from serving as both FA and underwriter on the same deal.

"This is a classic example of conflict of interest … The board should change G-23 and forbid this practice," she said in a speech and added the commission was launching a nationwide inquiry into

the municipal market.

The MSRB rewrote the rule to prohibit such role switching and the SEC approved it.

Northam said often such contracts boil down to “facts and circumstances,” which involve interpretations and can be very hard to enforce. Only MSRB and Securities and Exchange Commission can interpret MSRB rules he and other market participants said.

MSRB officials said last week that they do not comment on specific cases and declined to comment on these contracts.

But executive director Lynnette Kelly said the board would have concerns if dealers are obscuring their role in dealings with public officials. “Based on MSRB Rule G-23 prohibitions, we would be concerned if a dealer says it is not acting in a financial advisory capacity, but in fact is doing just that,” Kelly said. “Furthermore, the Dodd-Frank Act makes clear that financial advisors have a fiduciary duty to their issuer clients and we would be concerned if a dealer is acting as a financial advisor but not honoring its fiduciary duty.”