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MSRB's First Draft Municipal Advisor Rule Alarms Dealers.

WASHINGTON — The Municipal Securities Rulemaking Board on Thursday released a new draft rule that would govern the conduct of municipal advisors, alarming broker-dealers who fear a prohibition on business outside of an advisory relationship with an issuer could push dealer-affiliated MAs out of the market.

The draft Rule G-42, called "Duties of Non-Solicitor Municipal Advisors," codifies the language of the Dodd-Frank Act, which imposes a fiduciary duty on MA's to put their client's interest first before their own. The draft rule says MAs owe both a duty of loyalty and a duty of care to their municipal entity clients.

It would prohibit MAs and their affiliates from engaging in any other transaction in a principal capacity with a client, which some market participants read as barring MAs from engaging in any non-fiduciary business relationship running concurrent to the municipal advisory agreement. It would not affect Rule G-23's prohibition on underwriter role-switching, but is intended to ensure the highest level of objectivity among MAs.

This particular provision is a major sticking point for broker-dealers, who have long maintained that the MA section of Dodd-Frank was intended to rein in unregistered non-dealer advisors.

"We were stunned to see that the MSRB took the opposite approach," said Leslie Norwood, associate general counsel and co-head of the municipal securities group at the Securities Industry and Financial Markets Association.

Norwood said the draft rule's ban on acting as a principal in transactions outside the advisory relationship essentially pushes bank-affiliated MAs out of the market, because the fact that their banking arms might manage accounts for a municipal entity locks them out of being that entity's MA.

"We feel it unnecessarily limits issuer choice," Norwood said. "It really makes no sense to us."

Norwood, however, added that SIFMA is glad that the MA regulations have some more "meat and definition" on this rule, and that the group remains eager for the MSRB to complete other rules which will subject non-dealer advisors to the same level of regulation dealer-affiliated advisors are subject to under existing MSRB rules.

Neither Dodd-Frank nor the Securities and Exchange Commission's MA registration rule, which was approved in September and takes effect on Jan. 13, extends the full fiduciary duty to "obligated persons" such as conduit borrowers. But the MSRB has asked for public comments on whether it legally can, and should, extend the fiduciary duty to cover all MA clients, including conduit borrowers.

The MSRB said in its 36-page notice, that the goal of the draft standards is to promote "higher ethical and professional standards" for MAs. The fiduciary duty, or duty of loyalty, is defined in the

draft rule as requiring the MA to deal in the “utmost good faith” with municipal entities such as issuers and to serve their best interests “without regard to the financial or other interests of the municipal advisor.”

MAs would owe a “duty of care” to all clients, and are also be bound by the MSRB’s Rule G-17 on fair dealing.

MSRB executive director Lynnette Kelly said the rule is based on a large body of existing regulations.

“We drew on concepts established in our rules for municipal securities dealers, as well as the Investment Advisors Act of 1940,” Kelly said during a press call. “We believe the proposal is workable for municipal advisors of all sizes.” The rule lays out the broad principles of MA duties to clients, but also includes many more specific conduct rules, some which have already been established by the SEC, such as those on recordkeeping.

MAs would be required to possess the expertise to assist their clients. They would need to disclose in writing all “material conflicts of interest” at the outset of their municipal advisory relationship.

An MA would need to disclose whether and how much liability insurance it carries, or that it carries none. The MSRB has asked for comments on whether it should require MAs to have such insurance. MAs also would have to disclose at the beginning of the relationship any legal or disciplinary event that might affect the client’s evaluation of them.

Susan Collet, senior vice president of government relations at the Bond Dealers of America, said BDA is happy to have the first of the MA rules available for comment, and will look carefully at the principal transaction prohibition and the question of extending a fiduciary duty to cover obligated persons.

National Association of Bond Lawyers spokesman Bill Daly also said his group would be examining the rule very closely.” NABL is very pleased that the MSRB has gotten this important rule out so quickly and we want to congratulate them and thank them for their work,” Daly said.

National Association of Independent Public Finance Advisors president Jeanine Rodgers Caruso said NAIPFA will address specific concerns at a later date. “We appreciate the MRSB’s concept release and their willingness to allow ample time for comment on this important rule,” she said. “While many aspects of the release reflect what was in the MSRB’s 2011 proposal, there are additional mattes included within this release that merit thoughtful consideration.”

However, sources said the draft rule’s liability insurance provisions could also be a problem and that this kind of insurance isn’t even available in some states.

The draft rule contains the equivalent of a suitability rule for MAs, requiring advisors to have a reasonable basis to believe their recommendations are suitable for their clients. In that vein, it includes a “know your client” obligation that would require MAs to use “reasonable diligence” to know essential information about their clients. Such information would include anything necessary for the advisory relationship or required for compliance with laws and rules.

Fee-splitting arrangements would be prohibited between MAs and underwriters, but would be permitted for MAs and other providers of services to clients if disclosed at the outset of their relationships.

There would be a presumption that an MA would review the official statements of its issuer clients’

bond offerings, but the MA would not be required to do so if both parties agreed it was unnecessary. Agreement about an OS review would need to be included in the documents establishing the relationship, and those documents would have to be updated to reflect any change in the scope of services provided.

The MSRB said it would amend its Rules G-8 on books and records and G-9 on preservation of records to reflect the SEC's requirement that MAs retain for at least five years records of all communications, policies and procedures, the names of associated persons, and any other material documents dealing with its clients.

The MSRB's notice requests many comments, including on whether or not all fee-splitting arrangements should be prohibited, whether MAs should be required to obtain written acknowledgement that a client received the necessary disclosures, and whether MAs should have to disclose all legal or disciplinary actions related to individuals not working with clients.

The MSRB has set a comment deadline of March 10.

BY KYLE GLAZIER

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