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MSRB Files Exception to MA Conduct Rule's Principal Transaction Ban.

WASHINGTON – The Municipal Securities Rulemaking Board is proposing a limited exception to the controversial principal transaction ban in its proposed municipal advisor core conduct rule.

The MSRB filed the proposed amendment to its Rule G-42 on core duties of municipal advisors, with the Securities and Exchange Commission on Monday and asked that it become effective six months after SEC approval. The SEC previously published the MSRB's G-42 proposal for comment on May 8, but asked for an extension of up to 90 days on Aug. 6. The MSRB then published revisions to the rule and responded to earlier comments on Aug. 12.

Commenters were most concerned about the proposed rule's ban on an MA 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. They said it would make the rule overly burdensome and anti-competitive.

The MSRB said the proposed amendment responds to concerns that, without an exception for certain transactions, "the proposed ban would restrict the access of municipal entities to trusted financial advisors, limit their ability to obtain certain financial services and products, create undue burdens on competition, and impose unjustified costs for issuers."

Under the core portion of Rule G-42, MAs would owe a fiduciary "duty of loyalty" to their municipal issuer clients and be required "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 the financial or other interests of the municipal advisor."

It also mandates a less stringent "duty of care" for all clients that 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.

The amendment filed with the SEC draws from the procedures under which investment advisors are allowed to engage in principal transactions with clients.

The changes filed Monday describe three requirements for MAs to qualify for the principal ban exception and the types of transaction that fall under the exception.

MAs can only use the exception if they are registered broker-dealers under the Securities and Exchange Act of 1934 and that the accounts they want to use it for are brokerage accounts subject to the Exchange Act, as well as the rules of self-regulatory organizations of which they are a member. MAs also can only use the exception if they use their investment discretion on a temporary or limited basis, at their clients' discretion.

The MSRB allows for the exception to carry over to future principal transactions following an original principal transaction that met the amendment's requirements. For example, if an MA uses

the exception for one principal transaction with a municipal client, it can then use the exception for future principal transactions with the same municipal client that are directly related to the first transaction.

The third requirement in the amendment would limit an MA's principal transactions under the exception to sales to, or purchases from, a municipal client of U.S. Treasury securities, agency debt security, or corporate debt security.

If an MA is in compliance with those three requirements, it can then choose whether to pursue a transaction-by-transaction process or a process that is more complex but gives the MA the flexibility to obtain oral consent on a transaction-by-transaction basis instead of written consent.

If it chooses transaction-by-transaction, the MA must tell its municipal client in writing the capacity in which it is acting and get the client's informed written consent for the transaction, either before executing the transaction or after execution but before settlement.

If an MA opts not to pursue a transaction-by-transaction process, it must follow a six-step process. Neither the MA nor any of its affiliates can be the issuer or underwriter of a security that is the subject of the principal transaction and an MA also must get an executed written, revocable consent from its municipal client that would prospectively authorize the MA to directly or indirectly act as principal for its own account in selling a security to, or purchasing a security from, the client. The written consent must have been obtained after the MA explains to the client in writing the circumstances under which the MA may engage in principal transactions, the nature and significance of conflicts with the client's interests and how the MA will address those conflicts.

The process then requires the MA to inform its client either orally or in writing of the capacity in which it may act and get the client's consent either orally or in writing before executing each subsequent principal transaction. The MA would also have to send a written confirmation to the client saying that it disclosed that is may be acting in a principal capacity, the client authorized the transaction, and the MA sold or bought the security for its own account.

Finally, MAs would be, at least annually, required to send clients a list of all executed transactions in the client's account that relied on the exception, complete with the date and price. Each written disclosure would also have to include a statement about the client's ability to revoke its consent without penalty at any time by written notice.

Jessica Giroux, general counsel and managing director of federal regulatory policy with Bond Dealers of America, said the proposal is "very encouraging" and that BDA is pleased the MSRB has responded to industry comments.

Leslie Norwood, associate general counsel and co-head of municipal securities for Securities Industry and Financial Markets Association, said SIFMA is very pleased with the amendment and thinks it is helpful for issuers in the marketplace.

But executive director of National Association of Municipal Advisors Susan Gaffney disagreed with BDA and SIFMA, calling the amendment "a step backwards."

"The proposed amendment is further compromised by its complexity," Gaffney said. "The disclosure and consent model has been shown not to work well in other municipal market rulemaking. It is therefore surprising that such a structure has come forward, especially this late in the game, for Rule G-42."

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BY JACK CASEY

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