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Dealer Groups Want SEC to Disapprove MA Conduct Rule.

WASHINGTON – Two dealer groups are urging the Securities and Exchange Commission to disapprove the Municipal Securities Rulemaking Board's proposed municipal advisor core conduct rule, despite an amendment that would provide an exception to the rule's controversial principal transaction ban.

The Securities Industry and Financial Markets Association and Bond Dealers of America told the SEC in a comment letter that the exception to Rule G-42 is unworkable and would be overly burdensome. The Government Finance Officers Association also said in a letter to the commission that it doesn't support the rule and wants more clarification.

Leslie Norwood, associate general counsel and co-head of municipal securities for SIFMA, said the MSRB's changes to the principal transaction ban show the board "has acknowledged that it must move toward a more workable construct that will protect municipal entities while not unnecessarily increasing their costs." However, she added that, even though SIFMA wants to see the Rule G-42 rulemaking process completed, the exception is not appropriately tailored to be useful for municipal advisors and would include a number of procedural and operational burdens that will not help issuers or other municipal entities.

The SEC first published Rule G-42 for comment on May 8 and asked for an extra 90 days on Aug. 6 to make a decision. The MSRB then published revisions to the rule and responded to earlier comments on Aug. 12, before ultimately filing its second set of revisions, concerning the principal transaction ban, on Nov. 9.

Under the original and pending rule, MAs would owe a fiduciary "duty of loyalty" to their municipal issuer clients and would 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 [their] financial or other interests."

The rule 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 initial proposed rule would have prevented an MA 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.

That drew complaints from muni market groups. The MSRB then proposed an exception that would lift the ban if an MA is a registered broker-dealer under the Securities and Exchange Act of 1934 and the account it wants to use the exception for is a brokerage account subject to that act, as well as to the rules of the self-regulatory organization of which it is a member. An MA also could only employ the exception if it uses its investment discretion on a temporary or limited basis, at its clients' discretion. The exception would further only apply to sales to, or purchases from, a

municipal client of U.S. Treasury securities, agency debt securities, or corporate debt securities. The MSRB crafted the exception from procedures under which investment advisors are allowed to engage in principal transactions with clients.

If an MA meets the MSRB's basic requirements for the exception, it can then choose whether to get an issuer's written consent on a transaction-by-transaction basis or it can meet six requirements and get oral consent from the issuer for an indefinite number of transactions. If the MA chooses to obtain the exception on a transaction-by-transaction basis, then it must tell its municipal client in writing the capacity in which it is acting and get the client's informed written consent, either before executing the transaction or after execution but before settlement.

The six requirements for obtaining the exception for an indefinite number of transactions include the following. 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. The MA also must get an executed written, revocable consent from its municipal client that would prospectively authorize it 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 be obtained after the MA explains to the client in writing the circumstances under which it may engage in principal transactions, the nature and significance of conflicts with the client's interests and how it will address those conflicts.

The MA must 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 also must send a written confirmation to the client saying that it disclosed that it may be acting in a principal capacity, the client authorized the transaction, and that 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.

The market groups criticized the complexity of the exception, particularly the six requirements for blanket consent. Norwood also said the exception only addresses one of SIFMA's concerns, the ban's effect on fixed income securities, while avoiding the issue of complying with the relationship documentation and conflict disclosure requirements in the proposed rule. She added other SIFMA concerns, like those over the requirement that an MA investigate the accuracy of client representations, are stilled unaddressed. The Investment Company Institute has repeatedly raised concerns about the client representations portion of the rule and also filed a comment letter on the MSRB's revisions to the exception from the principal transaction ban.

Mike Nicholas, BDA's chief executive officer, said that while BDA recognizes the MSRB used the investment advisors procedures as a base, the exceptions "do not take into consideration the vast differences between brokerage operations and investment advisory operations."

Both Norwood and Nicholas took issue with the six requirements an MA would have to meet to be able to obtain blanket consent from the issuer to escape the ban for an indefinite number of transactions.

"The blanket consent alternative's requirement to obtain additional transaction-by-transaction consent totally undermines the utility of obtaining advance written consent, and presents challenging issues of documentation and recordkeeping," Norwood said.

She also said the exception should apply beyond registered broker-dealers and brokerage accounts and include MAs as well as affiliates that are either registered or acting under an exemption from registration, such as banks. SIFMA additionally is asking that the exception be available to affiliates of MAs and include the sales of money market instruments and municipal escrow investments.

Dustin McDonald, director and federal liaison for GFOA, reiterated GFOA's concern that the transaction ban could increase the costs issuers pay to their advisors.

"All of these restrictions and added costs will make it likely that even more firms will decide simply to not handle investments of bond proceeds or require their municipal entity clients to open more expensive advisory accounts," McDonald said. He also raised several questions to assess the workability of the transaction-by-transaction option the MSRB put forward as part of its exception from the ban on principal transactions.

National Association of Municipal Advisors executive director Susan Gaffney said there is a lot of due diligence on the disclosure of relationships in the rule, which in the past, " has not worked very well" with regard to MSRB Rule G-23 on financial advisor activities. For that reason, she said NAMA would like to "make sure that those standards are as robust as possible" to ensure all parties, but especially issuers, are protected.

THE BOND BUYER

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DEC 2, 2015 3:35pm ET

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