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Groups Threaten to Challenge Constitutionality of Revised G-37.

WASHINGTON – Three groups are threatening to challenge the constitutionality of the Municipal Securities Rulemaking Board's revised pay-to-play rule for municipal advisors.

The revised rule, approved this month by the Securities and Exchange Commission, would take effect beginning Aug. 17. It would put non-dealer muni advisors and MAs acting as third-party solicitors on a par with dealer advisors and underwriters by restricting their political contributions to issuer officials to prevent them from engaging in pay-to-pay practices.

The Center for Competitive Politics, the New York Republican State Committee, and the Tennessee Republican Party, all urged the SEC in comment letters to disapprove the Rule G-37 revisions, warning they would restrict political speech and violate the First Amendment to the U.S. Constitution.

The CCP is a nonprofit organization that promotes and defends free speech and other First Amendment rights through litigation, communication, activism, and education. The two state Republican groups challenged a previous rule from the SEC aimed at preventing investment advisors from engaging in pay-to-play practices. The U.S. Court of Appeals for the District of Columbia dismissed that lawsuit on a technicality, finding the two groups missed the 60-day deadline to challenge the rule after it went into effect.

Jason Torchinsky, a partner at Holtzman Vogel Josefiak Torchinsky PLLC and one of the lawyers in the Republican committees' challenge to the IA rule, said Wednesday that the SEC's approval of the changes is a "regulatory expansion of limits on the right of individuals to engage in First Amendment protected activity" that "should be subject to a court challenge." He added he believes a challenge will be brought but said details are not yet available.

David Keating, the CPP's president, said the group is "very disappointed the SEC did not consider less restrictive alternatives that could avoid limiting First Amendment rights" and that the rule "is highly vulnerable to a challenge in court."

Rule G-37 was challenged by an Alabama bond dealer William Blount soon after it was approved for dealers in April 1994. He argued the rule violated his constitutional right to free speech. The DC appellate court rejected that argument in 1995, ruling G-37 was "narrowly tailored to serve a compelling government interest." The Supreme Court declined to take up an appeal of that ruling.

But that was a different high court. More recent Supreme Court decisions have overturned restrictions on politically motivated expenditures, such as in Citizens United vs. Federal Election Commission in 2010.

In announcing the SEC's approval of the revised G-37, MSRB executive director Lynnette Kelly said, "The integrity of the municipal market will be well-served by the regulations to help ensure that all municipal advisors that do business with state and local governments do so based on the merits of

their work and not on financial influence."

She added that the MSRB has "conducted its municipal advisor rulemaking in the most transparent and rigorous manner" by incorporating significant public and industry input. The self-regulator is "pleased to have created balanced rules that protect the interests of state and local governments," Kelly said.

The pay-to-play rule, along with other recently approved regulations on core duties of municipal advisors and gifts and gratuities limitations, is part of the MSRB's multi-year effort to extend its regulatory regime to municipal advisors to comply with a mandate of the Dodd-Frank Act.

The revised Rule G-37 will prevent both dealers and MAs from engaging in negotiated municipal business with an issuer for two years if the firm, one of its municipal finance professionals or municipal advisor professionals, or a political action committee that is controlled by either the firm or a professional associated with the firm, makes a significant contributions to an issuer official who can influence the award of negotiated muni bond business for dealers or MAs.

However, an MFP or MAP will be allowed to give a de minimis contribution of up to $250 to any candidate for whom he or she can vote for without triggering the ban. There is still no such exception for a firm.

The rule also divides MA firms into two categories, those that act as third-party solicitors and those that do not. Under the approved rule, an MA third-party solicitor is generally an MA that solicits an issuer or other municipal entity for compensation, even if that MA also provides advice to municipal entities.

Dealers and non-dealer MAs can trigger the two-year ban in different ways.

Dealers can only be subject to a ban on municipal securities business if a contribution is made to an official who can influence the selection of a dealer. Similarly, a non-solicitor MA can only be subject to a ban on municipal advisory business if a contribution is made to an official who can influence the selection of an MA. A temporary ban on negotiated municipal advisory business would include both a ban on advising the issuer or other municipal entity on certain matters and soliciting the municipal entity on behalf of third-party dealers, municipal advisors, and investment advisers.

Dealers that are also MAs could also be subject to a "cross ban" on business, consistent with the type of influence held by the official to whom the contribution was made. A "cross ban" would treat a dealer-MA firm as a single economic unit. For example, if an MFP or MAP of the firm makes a contribution to an official who can influence the selection of dealers and MAs, the firm is subject to a temporary ban on both types of business. However, if an MFP or MAP of the firm makes a contribution to an official who only has influence over one type of business, the firm would be subject to a two-year ban on only that business.

The factors triggering a temporary ban on business for municipal advisor third-party solicitors differ from those for non-solicitor MAs. For MA third-party solicitors, the ban on negotiated municipal advisory business would apply if the official getting the contribution has influence over selecting MAs, dealers, or investment advisors. If a dealer hires a municipal advisor third-party solicitor, the dealer also may be subject to a two-year ban on municipal securities business if the solicitor contributed to an official who could influence the selection of dealers. Similarly, if a municipal advisor hires an MA third-party solicitor, the municipal advisor also may be subject to a ban on municipal advisory business if the solicitor contributed to an official who has influence over selecting MAs.

The SEC also approved related changes to MSRB Rules G-8 and G-9 on books and records and preservation of records. The rules will now require dealers and MAs to disclose to the MSRB on a quarterly basis information about contributions made to issuer officials, payments made to political parties of states or political subdivisions, contributions made to bond ballot campaigns, and muni transactions done with issuers. A new requirement for MA third-party solicitors will require them to list the names of the parties from whom they've solicited business as well as the nature of the business solicited.

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BY JACK CASEY

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