Bond Case Briefs

Municipal Finance Law Since 1971

SEC Examiners Find MA Violations, Expect More Reviews Next Year.

NEW ORLEANS – Securities and Exchange Commission examinations of municipal advisors over the past two years found fiduciary duty and fair dealing violations, said SEC officials who cautioned the number of MA exams will increase in 2017.

The officials from the SEC's Office of Compliance Inspections, and Examinations discussed the findings from the examination initiative during a panel at the National Association of Municipal Advisors annual conference here.

The initiative was announced in August 2014 and was designed to assess non-dealer MAs' compliance with registration, disclosure, fair dealing, supervision, books and records, as well as training and qualifications requirements. The SEC is responsible for examining all non-dealer MAs while the Financial Industry Regulatory Authority is responsible for dealer MAs.

After a firm examination is completed, OCIE sends either a deficiency letter spelling out the violations it found or a no further action letter. While the deficiency letter is not public and does not necessarily imply there will be enforcement, the representatives said they may pass certain findings on to their enforcement colleagues in the SEC.

Robert Miller, an OCIE supervisory attorney and examining manager, emphasized that when a firm receives a no further action letter, it should be aware that it is not the same thing as "a gold star."

Suzanne McGovern, an OCIE assistant director, said that as of Sept. 13, approximately 670 firms have registered with the SEC, 518 of which are non-dealer municipal advisors. Additionally, 4,900 individuals have each filed a Form MA-I to provide advisor information.

OCIE examined 50 non-dealer municipal advisors and two broker-dealers in 2015 and closed 67 examinations of non-dealer municipal advisors in 2016, according to McGovern.

She added that OCIE's focus on examinations will continue into next year as the office and the MA community both become adjusted to newly effective conduct rules for municipal advisors, such as the Municipal Securities Rulemaking Board's Rules G-20 on gifts and G-37 on political contributions. OCIE recently outlined its resource allocation for the next year and determined that one of the office's priorities for 2017 will be independent MAs, she said.

"That means probably the number of examinations this year will go up," she said. The office uses risk assessments it does of the firms to determine which ones to examine and when to begin the processes.

While examinations in 2015 mainly uncovered what Miller called "technical violations," such as those related to registration and books and records, examinations in 2016 found instances of fiduciary duty violations. The Dodd-Frank Act gave MAs a fiduciary duty to put their clients' interests first. The more recently enacted MSRB Rule G-42 detailed MA duties of care and loyalty.

As an example of the commission's fiduciary duty findings, Miller described a series of discoveries the office made about three individuals who were employed with an MA and were also working at a related broker-dealer. The individuals pursued several deals while working with a municipality in an advisory capacity and the OCIE examiners found that when it came time to choose an underwriter for the municipality's deals, they picked their own dealer without notifying the municipality of their ties.

"In that case, clearly there's a conflict of interest," Miller said about the concerns with the individual's breach of their fiduciary duty. "If they're double-dipping, what is the likelihood that they are going to look out for the best interest of the municipality as opposed to themselves?"

While Miller did not explicitly identify the parties in the case, the facts he described are very similar to an SEC enforcement action released in March where the commission settled with Kansas-based municipal advisor Central States Capital Markets, its chief executive officer John Stepp, former vice president Mark Detter, and current vice president David Malone. The firm and employees were financial advisor for an issuer in a muni transaction and then selected a broker-dealer where the three men also worked to underwrite the bonds, according to the SEC.

Miller said OCIE examiners have also uncovered examples of fair dealing violations related to excessive fees.

He gave an example of a deal involving a small community in the Southeast that needed to buy new equipment for its school district. The community reached out to a municipal advisor and the MA recommended it issue bonds. However, given the small nature of the deal, the MA initially had trouble finding other deal participants and decided it had to do more due diligence. It eventually found participants with which the firm had worked with before, but, when the bonds were issued and the deal was completed, OCIE found that the MA ended up getting a fee of 22% of the bond proceeds.

"I think that is the definition of excessive," Miller said.

OCIE's excessive fee determinations deal more with facts and circumstances he added, saying examiners will continue to look at things like the MA's expertise, the time it has spent in the industry, the level of qualifications, and the complexity of the issuance when drawing such conclusions.

Miller and McGovern said OCIE also found registration as well as books and records violations during the two-year examination period.

Common violations included registering with the Municipal Securities Rulemaking Board as an MA but not the SEC, listing an incorrect name on the registration form, and not properly keeping a general ledger for the firm.

Miller recommended that firms trying to keep a good general ledger think about the practice from a "follow the money" standpoint. He said the idea is to allow examiners, when they visit, to see how money came in, who got paid, and what the money was getting paid to.

"The key thing for us … is more documentation is better," he said. "It allows us to ask intelligent questions."

Other violations related to documentation included failures to have written supervisory procedures (WSPs) or not having WSPs that were tailored to the firm's operations. They gave an example of firms that, when asked about their WSPs, would provide copies of MSRB and SEC rules and simply

say that they follow each of the rules' components.

"Things like that will definitely get attention from the SEC," Miller said.

He added that examiners also saw some firms that had comingled email addresses or credit cards for both individuals and the firms. They also found a number of individuals, each of which had a Form MA-I that had not been updated and thus had them registered with two different firms. McGovern said that OCIE has found "probably about 50% of municipal advisors are not filing their amendments" to keep the regulators as well as their information updated.

OCIE is planning to put out a risk alert describing its findings as a "last piece" of the initiative, according to McGovern. She said the risk alert may take longer to be released because it has to get SEC approval, but that once it is made public it can help MAs strengthen their compliance programs.

The Bond Buyer

By Jack Casey

October 7, 2016