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SEC Settles Charges Against Municipal Underwriter for Unfair Practices and Misleading Advertising in Connection With its Distribution of New Issue Securities: Ballard Spahr

Summary

The U.S. Securities and Exchange Commission (SEC) announced that it has settled charges against an underwriter, its owner, and chief compliance officer for violations of MSRB Rules G-21 on misleading advertising and G-17 on fair dealing.

The Upshot

According to the December 22, 2020, SEC Order implementing the settlement:

- During the period in question, the underwriter sold roughly 76 percent of the par value of its offerings to broker-dealers, rather than directly to investors, with 35 percent of the par value of those offerings sold to a single broker dealer—who then resold the bonds to investors at prices higher than the initial offering prices. According to the SEC, this practice conflicted with representations made by the underwriter to the issuers about its distribution capabilities.
- The SEC asserted that the underwriter's practice of using broker-dealers to resell underwritten bonds resulted in pricing that created profits for the broker-dealer intermediaries that would have been captured by the issuer had the bonds been sold directly to investors at those prices.
- MSRB rules, in and of themselves, do not prohibit an underwriter from selling new issue municipal securities to broker-dealers—but the SEC has articulated a position about these practices and the theoretical harm they could cause municipal issuers.

The Bottom Line

The SEC's use of fair dealing and advertising rules to promote regulatory goals that cannot be regulated directly should be noted by underwriters who sell new issue municipal securities to broker-dealers in order to manage their risk to capital, especially in volatile interest rate environments or where the demand for the issue is weak.

As a result of this Order, underwriters should review the materials they use to respond to issuer RFPs for underwriting services and their internet advertising content. Underwriters should also consider if and under what circumstances they should disclose to municipal issuers the SEC's views of the potential harm to issuers of the pricing dynamics described above.

While the Order effectively mandates additional Rule G-17 disclosures to municipal issuers about their distribution practices when they deviate from other representations, the SEC may be moving toward a view that underwriters should make these Rule G-17 disclosures even in the absence of contrary representations, if they are underwriting bonds for smaller inexperienced issuers who are not represented by municipal advisors in the pricing process. It is unclear whether the Order is a harbinger of increasing scrutiny by the SEC of underwriter pricing and distribution practices for

issuers unrepresented by municipal advisors. The Order also articulates the SEC's views of the important role they feel a municipal advisor plays in assisting municipal issuers, especially smaller unsophisticated issuers, in pricing underwritten transactions.

FULL ALERT

The U.S. Securities and Exchange Commission (SEC) announced that it has settled charges against an underwriter, its owner, and chief compliance officer for violations of MSRB Rules G-17 and G-21. According to the December 22, 2020, SEC Order implementing the settlement, during the time period in question, the underwriter sold roughly 76 percent of the par value of its municipal securities to broker-dealers, rather than directly to investors, with 35 percent of the par value of those offerings sold to a single broker-dealer—who then resold the securities to investors at prices higher than the initial offering prices.

The SEC found that, notwithstanding this "regular practice," the underwriter at the same time represented on its website and in RFP responses to issuers that the underwriter had "an extensive customer base which would allow it to locate suitable investors for the bonds and sell the bonds at competitive interest rates" among other similar representations.

According to the Order, because underwriters must make truthful and accurate representations about their capacity and resources to perform their underwriting services and not misrepresent or omit material facts, the SEC found that the underwriter's practice was a violation of MSRB's Rule G-17 on fair dealing. The SEC also alleged that the underwriter violated MSRB's Rule G-21 on advertising because its website is considered a professional advertisement, and the statements about its distribution capabilities were false and misleading.

The Order described the SEC's position concerning the effects that these practices may have on issuers and the pricing of new issue municipal securities. According to the SEC, the underwriter's practice of using broker-dealers to resell underwritten municipal securities creates the risk that an issuer's securities would not be sold at competitive interest rates, because the broker-dealer's commission is added to the initial offering prices, resulting in higher prices and lower yields. Under this reasoning, if the underwriter has sold the municipal securities directly to investors at those same prices and yields, the issuer could potentially receive more in proceeds or realize lower yields. MSRB rules, in and of themselves, do not prohibit an underwriter from selling new issue municipal securities to broker-dealers.

Although the SEC may not have a direct path to eliminating the intermediary profits of broker-dealers in this context absent an unrelated rule violation—in this case alleging misleading advertising under MSRB Rules G-21 and fair dealing violations under G-17—the SEC has articulated a new position about these practices and the theoretical harm they could cause municipal issuers.

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