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Intriguing FINRA Enforcement Action In the Bond Market: More to Come? - Arent Fox

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In 2021, the Financial Industry Regulatory Authority (FINRA) enforced the "best judgment" requirement for publishing prices related to municipal securities. In the same action, FINRA found that the broker-dealer violated MSRB rules related to fair dealing and supervision.

In addition, in June, FINRA reminded broker-dealers of their best execution obligations which are derived from common law agency principles and fiduciary obligations. The best execution obligation is incorporated in applicable MSRB rules and, through judicial and Securities and Exchange Commission (SEC) decisions, in the anti-fraud provisions of the Federal securities laws.

These actions may signal that FINRA is preparing to bring additional enforcement actions relating to the best judgment and best execution rules. [1]

In fact, on September 14, 2021, the SEC Chairman testified before the Senate Banking, Housing, and Urban Affairs Committee, where he stated (the "Senate Banking Gensler Testimony"):

> The U.S. capital markets represents 38 percent of the globe's capital markets. [In addition to examining the Treasury market], I've asked staff for recommendations on how we can bring greater efficiency and transparency to the non-Treasury fixed income markets – corporate bonds, a $11 trillion market; municipal bonds, a $4 trillion market; and [mortgage and] asset-backed securities (which back mortgages, automobiles, and credit cards), a $13 trillion market.This market is so critical to issuers. It is nearly 2.5 times larger than the commercial bank lending of about $10.5 trillion in our economy.

Relevant Governmental Regulators

FINRA

FINRA is a self-regulatory organization working under the supervision of the SEC. As the largest dispute resolution forum in the securities industry, FINRA resolves securities-related disputes. It also educates investors, and enacts and enforces rules governing the ethical activities of all registered brokers and registered broker-dealers in the United States.

As a self-regulatory organization, the FINRA Board is comprised of both regulated industry

representatives and public representatives.

According to FINRA Rule 2010, registered broker-dealers and registered brokers are required to:

> [o]bserve high standards of commercial honor and just and equitable principles of trade

FINRA primarily issues rules with respect to the corporate securities market. This market's size was $10.6 trillion, with new issuance volume of $2.3 trillion in 2020.

MSRB

Like FINRA, the MSRB is a self-regulatory organization under the oversight of the SEC. In forming the MSRB, the Senate Committee on Banking, Housing, and Urban Affairs expressed hope in 1977, "that a self-regulatory body like the MSRB would develop prophylactic rules for the industry, which would preemptively deter unethical and fraudulent practices". [2]

Its mission, as set forth on the MSRB's web page, is to protect investors, state and local governmental issuers, other municipal-related entities (including conduit borrowers) and the public interest.

The MSRB was created in the 1970's, when New York City was on the brink of default, to prevent fraudulent and manipulative acts and practices of some broker-dealers. Over the ensuing decades, there were other crises impacting the municipal industry including (i) the $2.3 billion default of bonds issued by the Washington Public Power System Supply ("WPPSS"; commonly referred to in the bond industry as 'Whoops') in 1983 caused by increased costs and delays in nuclear power plant construction, and related inadequate disclosure to investors, (ii) the bankruptcy of Orange County, California in 1994 precipitated by its overreliance on risky investments, including derivatives, which were also not adequately disclosed [3] and (iii) the bankruptcy of Jefferson County, Alabama due to the increased expense of rebuilding its sewer system necessitated by U.S. Environmental Protection Administration violations, and its overreliance on costly interest rate swaps for the variable rate bonds it issued to finance the sewer system improvements.

In 2020, the municipal securities market's size was $3.9 trillion, with new issuance volume of $494 billion. According to Moody's Investors Service, Inc., the default rate average from 2010-2019 was 0.10% for municipal securities compared to a default rate of 2.25% for corporate securities.

Rulemaking

Historically, MSRB Rules were "principles-based" with specific guidance given where appropriate. MSRB is in the process of updating its rules and related guidance.

MSRB Rules generally fall into the following categories:

professional qualification

- fair practice rules to protect investors, municipal entities, conduit borrowers and the general public – *best execution, suitability, material investor and conflicts of interests disclosures; transparent pricing; pay-to-play; municipal advisor obligations*
- uniform practice – *standard confirmation, underwriting and settlement procedures*
- market transparency – *primary offerings; real-time reporting of trade prices*
- regulated entity administration – c*ompliance; proper recordkeeping; supervision of professionals*

According to the MSRB, these rules require regulated entities to:

> observe the highest professional standards in their activities and relationships with customers and municipal entities, and go significantly beyond the general anti-fraud principles of the federal securities laws

Lack of Enforcement Powers

Notwithstanding the foregoing rulemaking authority, responsibility for inspection and enforcement of MSRB Rules rests with the following Federal government and self-regulatory bodies:

- FINRA
  securities firms
- SEC
  municipal advisors, and all securities firms and banks
- Federal Deposit Insurance Corporation (FDIC)
- Board of Governors of the Federal Reserve System
- Office of the Comptroller of the Currency (OCC)
  regulated banks

Recent Board Developments

MSRB's Board has both representatives from regulated entities that it is required to regulate and public representatives. Recently, there have been structural changes implemented at the Board level. See "Notable Recent Observations – Governance/Compliance Developments – MSRB" below.

Best Judgment Standard
Municipal Securities

General

MSRB Rule G-13 requires that dealers, brokers or their authorized agents use their "best judgment" when quoting prices related to municipal securities.

Indicators that a price quotation is in the broker/dealer's "best judgment" include a price quotation's reasonable relationship to the fair market value of the securities at the time the quotation is made. According to an April 1988 MSRB interpretation of Rule G-13, relevant factors for municipal security price quotations include a dealer's (i) current overall and security-specific inventory position, and (ii) anticipation of the market price for the securities. Finally, a broker or dealer would be acting outside of its best judgment if it is not prepared to buy or sell the securities at the price published.

Violations

Responding to concerns about the meaning of "best judgment" and its practical application, the MSRB provided the following three examples of how to operationalize the best judgment rule (the "MSRB 1977 interpretation letter") :

Bid Restrictions – Bonds Subject to Redemption
In the first example, a dealer who knowingly submits a bid for general market bonds that have been called by the issuer, at a price more appropriate for bonds not subject to redemption, is acting "unethically." Such actions would run afoul of the "free and open" nature of municipal securities

markets. In that same example, should a dealer on the other side of a trade accept the bid, this dealer arguably is acting outside of its best judgment because it is presumed to be aware of the bonds' called status. Although such a transaction between professionals would be insufficient to sustain a fraud charge, the acceptance of the trade would not relieve the bid-making dealer from a MSRB Rule G-13 enforcement action.

Bond Valuation Mismatches
A dealer who submits a bid for bonds based on valuations from independent sources that mistake the nature of the proffered securities is the second example of an action outside of the best judgment rule. Under these circumstances, if the dealer knew that the valuation was mistaken, its bidding would also violate this rule [4].

Lack of Any Dealer Diligence
Finally, a dealer who makes a bid or an offer on a security, having no knowledge of the value of the security or of comparable securities, is the third example of a situation where MSRB would likely recommend that an enforcement action be brought against a broker or dealer. MSRB specifically stated that a price quotation that is "pulled out of the air" is not based on the dealer's best judgment and is against the promotion of free and open markets in municipal securities.

Corporate Securities

Best Execution

Pursuant to FINRA Rule 5310, a broker-dealer or broker is required to use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.

Parallel provisions are contained in MSRB Rule G-18.

Fair Quotations

Generally, under FINRA Rule 5220 and MSRB Rule G-13(b), no broker-dealer may make an offer to buy or sell a security at a stated price unless a bona fide price and the broker-dealer is prepared to purchase or sell at such price and at such conditions stated at the time of such offer.

Suitability
A broker-dealer must have a reasonable basis to believe that a recommended transaction or investment strategy is suitable for a customer, both from a municipal and a corporate perspective. This is to be based upon the reasonable diligence of the broker-dealer including, but not limited to, investment objectives, and experience, liquidity needs, and risk tolerance.

Fair Dealing Requirement
Municipal Securities

General

Under MSRB Rule G-17, which regulates conduct of municipal securities and municipal advisory activities, each broker, dealer and municipal advisor has a duty to deal fairly with all persons. This rule prohibits any deceptive, dishonest or unfair practices.

MSRB Rule G-17 contains for applying the rule in various contexts. These notices include guidance on use of the rule as a remedy for actions such as: (i) delaying delivery of securities to customers (October 13, 1983); (ii) conduct of syndicate managers (on selling short, December 21, 1984); (iii)

altering settlement issue dates (February 26, 1985); (iv) charging excessive fees (July 29, 1985); (v) disclosure obligations of prepayment of principal (March 19, 1991); (vi) disclosure of material facts (on original issue discount bonds, January 5, 2005); (vii) bond issue ratings (January 22, 2008); and (viii) protection of municipal entities (August 2, 2012).

The rule provides that customers or other parties harmed by violations of MSRB Rule G-17 may seek recovery through MSRB's arbitration program or through litigation.

Recent Effectiveness of Fair Dealing Interpretive Notice

General

Importantly, the aforementioned interpretive notice relating to the protection of municipal entities was amended on November 6, 2019, with an effective date of November 30, 2020. It was subsequently amended on February 16, 2021, with an extended effective date of March 31, 2021 (the "2021 Fair Dealing Interpretive Notice"). It noted that the prior interpretative notice, dated August 2, 2012, and related interpretations (collectively, the "2012 MSRB G-17 Interpretative Notice") will only apply to prior underwriting relationships.

The 2021 Fair Dealing Interpretive Notice states that MSRB Rule G-17 does not merely prohibit deceptive conduct on the part of the registered broker-dealer and broker, but also establishes a general duty to deal fairly with all persons including, but not limited to issuers, *even in the absence of fraud*.

Lack of Fiduciary Duty
However, a broker-dealer does not have a fiduciary duty to the issuer under Federal securities laws and, therefore, is not required to act in the best interests of the issuer without regard to its own financial or other interests. Consequently, the broker-dealer may not discourage issuers from retaining a municipal advisor or otherwise imply that hiring a municipal advisor is redundant as the municipal advisor, unlike the broker-dealer, does have a fiduciary duty to the issuer. [5]

Required Transaction-Specific Disclosures
A broker-dealer is required to deliver transaction-specific disclosures where it has recommended a financing structure or product to an issuer. Such disclosures are to be specific rather than general in nature and, among other things, be based upon the type of structure or product recommended, as well as the issuer's knowledge and experience regarding such structure or product.

Additional Complex Municipal Securities Requirements

In the 2021 MSRB G-17 Interpretive Notice complex municipal securities, financing requires even more particularized transaction-specific disclosures than do routine financing structures or products. Complex municipal securities financings include, but are not limited to, variable rate demand obligations (VRDOs), financings involving interest rate swaps and financings in which interest rates are benchmarked to an index (e.g. LIBOR, SIFMA or SOFR). The fact that a structure or a product has become relatively common in the market does not reduce its complexity.

Specifically, the broker-dealer must disclose the related material characteristics and material financial risks of this type of complex municipal securities structure or product to the issuer. By way of example, for an interest rate swap, such disclosures include: (i) the material characteristics such as material economic terms, material operational issues, and material rights and obligations of the parties, and (ii) the material financial risks such as market, credit, operational and liquidity risks.

Such disclosures should be sufficient to allow the issuer to assess the magnitude of its potential

exposure, and that there may be accounting, legal and other associated risks. The 2021 Fair Dealing Interpretive Notice also notes that such a registered entity may also be subject to Commodity Futures Trading Commission (CFTC) and SEC rules.

In addition, any incentives the broker-dealer receives in recommending a complex municipal securities financing must be disclosed.

Conduit Borrower Obligation

Notably, the 2021 Fair Dealing Interpretive Notice does not set out the broker-dealer's duties to other parties to a municipal securities financing such as conduit borrowers, but notes that MSRB Rule G-17 requires that an underwriter deal fairly with all persons involved in the financing.

Corporate Securities

General

To supplement FINRA Rule 2010, FINRA has a general rule that a registered broker-dealer or broker cannot effect any transaction in, or induce the purchase or sale of, any security by any manipulative, deceptive or other fraudulent device or contrivance.

Additional Complex Corporate Securities Requirements

As with municipal securities, FINRA has additional requirements for complex securities such as interest rate swaps. However, these requirements are tied into a registered entity's suitability obligations under FINRA Rule 2111.

Supervision

Municipal Securities

MSRB Rule G-27, focusing on supervision, creates an obligation on the part of brokers and dealers to supervise certain activities in order to ensure compliance with MSRB Rules and the Securities Act of 1933, as amended, and to establish a system of supervision of the municipal securities activity of each dealer and certain related employees. The supervisory procedures must be in writing, contain instructions for regular internal inspections of activities – with the goal of detecting and preventing violations of the applicable rules – and include instructions for the review of incoming and outgoing correspondence of its municipal securities representatives.

Finally, each dealer is required to designate a principal to establish, maintain and enforce supervisory control policies and procedures that comport with the municipal securities activities of the dealer, in addition to the specific procedures required in para. (f) of the rule. MSRB Rule G-27's interpretations address questions regarding who may be designated with supervisory responsibilities (branch office managers, municipal securities principals and sales principals) and procedures for review of correspondence with the public. Additional clarifications are laid out in interpretive letters.

Corporate Securities

Generally, the registered broker-dealer or broker must (i) designate chief compliance officers and (ii) have in place processes to establish, maintain and review policies and procedures reasonably designed to achieve compliance with applicable FINRA Rules and Federal securities laws and regulations.

The broker-dealer's supervisory system must provide, among other things: (i) written procedures, (ii) designation of an appropriately registered principal with authority to carry out the supervisory responsibility for (a) each type of business requiring registration and (b) each supervisory jurisdiction/branch office, (iii) assignment of each registered person to an appropriately registered representative or principal who is to be responsible for supervision of said person's activities, (iv) internal inspections and (v) importantly, a review and investigation of transactions that are reasonably determined to violate the Securities Exchange Act of 1934, as amended, or FINRA Rules prohibiting manipulative and deceptive devices.

Notable Recent Observations

Governance/Compliance Developments

MSRB

At the end of December 2019, *The Bond Buyer* reported that many of its senior officials left the MSRB during 2019 including its Chief Executive Officer, Chief Regulatory Officer and General Counsel. Starting in Fall 2020, these officers were replaced. One of the examination priorities of the SEC's Division of Examinations is the effectiveness of MSRB's policies, procedures and controls.

In Fiscal Year 2021, the MSRB implemented certain structural changes to its Board including, among other things (i) tightening the independence standard of public representatives on the Board by requiring a minimum of five (5) years (versus two (2) years) of separation from a regulated entity; (ii) splitting its Nominating and Governance Committee into two (2) separate committees – one focusing on Board nominations and the other focusing on Board governance; (iii) requiring that the chair of its Nominating, Governance and Audit Committees be public representatives and not regulated entity representatives from the Board, and (iv) the re-establishment of two advisory groups – the Compliance Advisory Group and the Municipal Fund Securities Advisory Group.

At its recent quarterly board meeting, the MSRB (i) selected a new Chair, (ii) announced that the Chief Risk Officer will assume the Chief Financial Officer role from the Chief Operating Officer who had a dual role, presumably leaving a vacancy in the Chief Risk Officer role, and (iii) stated it will soon announce the names of four (4) new board members to start on October 1, 2021. The new MSRB board members were announced on August 4, 2021.

Broker-Dealers

It should be noted that some of the largest banks have recently replaced their Chairs, Chief Executive Officers, Chief Compliance Officers and Chief Risk Officers. [6]

SEC

As part of the 2021 Examination Priorities, the Division of Examination also highlighted (i) the importance of internal compliance programs and Chief Compliance Officers at regulated entities, (ii) broker-dealer rules, in both the corporate and municipal bond markets, relating to best execution, pricing and mark-ups, (iii) Reg BI compliance and whether registered investment advisors have fulfilled their fiduciary duties of care and loyalty to their clients, and (iv) in the municipal securities area, whether municipal advisors have met their fiduciary duty obligations to municipal entity clients, including the disclosing of and managing of conflicts of interest and documentation of the scope of their client engagements.

FINRA Arbitration Requirements

FINRA recently reminded its member firms about requirements when using pre-dispute arbitration agreements for customer accounts. In particular, it noted that FINRA Rules do not allow class action claims in arbitration, specifically restricting members' actions preventing customers from bringing or participating in judicial class actions by adding class action waivers in these pre-dispute arbitration agreements.

As FINRA is by far the largest dispute forum for the U.S. securities industry, this is an important protection for investors.

Regulation Best Interest (Reg BI)

Corporate Securities

Adopted by the SEC in 2019, the Regulation Best Interest rule set a new standard of conduct for broker-dealers and their associates that go beyond the existing suitability obligations in FINRA Rule 2111. Reg BI requires that broker-dealers and their associates act in the best interest of a retail customer when making recommendations for any securities transaction or an investment strategy involving securities. Reg BI is not applicable to commercial customers.

Incorporating the care and conflict of interest obligations, and other key principles in the fiduciary duties of care and loyalty under Section 206(1) and (2) of the Investment Advisers Act of 1940, as amended, the goal of Reg BI is to align the broker-dealer standard of conduct with the reasonable expectations of retail customers. Two main indicators that a broker-dealer is acting in the best interest of its retail customers are: (i) making recommendations that do not prioritize the interest of the broker-dealer or its firm ahead of the interests of the retail customer; and (ii) establishing, maintaining and enforcing policies and procedures aimed at facilitating full and fair disclosure of any conflicts of interests.

The rule notes that disclosure is insufficient to meet the standard of conduct established by Reg BI.

Municipal Securities

In March, the MSRB indicated that the Reg BI principles would soon apply to bank dealers whose retail investment products and offerings include municipal securities. This is important as over two-thirds of municipal securities are held by individual investors either directly or through mutual funds.

Rules Equally Applicable to Corporate Bond Market

Although the instant case related to bidding on municipal securities, parallel rules apply to the corporate bond market as highlighted above.

To Enforce or Not to Enforce

Enforce

Enforcement of the rules set forth in this *Client Alert*, and other existing rules by the SEC, FINRA and the MSRB, is critical for the proper functioning of both the municipal and corporate bond markets. This will ensure the fair, transparent and efficient operations of these essential financial markets.

Not to Enforce

On the other hand, as quoted in the previously mentioned Bond Buyer article with respect to FINRA's enforcement action of the best judgment standard that is the first legal topic of this Client

Alert, a representative of Bond Dealers of America [7] stated that:

> *One of our concerns is that this case could establish compliance standards for the market more broadly. We don't have any problems with compliance standards, but enforcement cases are not the way to establish compliance standards.*

Answer to the Question
We leave it to the reader to decide which is the best path to assure compliance with the applicable MSRB and FINRA Rules, and related supervision standards, in the municipal bond and corporate securities markets.

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[1] During the publication of this writing, our prediction rang true. In late August, the SEC fined a firm and its former CEO for failing to disclose conflict of interest.

[2] See MSRB Interpretation of February 24, 1977 of MSRB Rule G-13 MSRB 1977 Interpretation Letter, citing the Senate Report 94-75, 94th Cong., 1st Sess., 42-32.

[3] This bankruptcy caused a significant delay of the lead author's simultaneous pricing of life care facility bonds issued by Orange County, New York.

[4] Although not addressed in the MSRB 1977 Interpretation Letter, it is our belief that the best judgment rule would also be violated, if based upon reasonable diligence, the dealer should have known that the valuations were erroneous.

[5] The fair dealing rule, MSRB Rule G-17, relates to both solicitor municipal advisors (those who solicit on behalf of third-parties such as broker-dealers) and non-solicitor municipal advisors. In addition, a new draft rule highlights that solicitor municipal advisors, as compared to non-solicitor municipal advisors, do not have a fiduciary duty to municipal entities and conduit borrowers but are required to (i) have a reasonable basis for their representations, (ii) refrain from making misrepresentations that they know or should know are inaccurate or misleading, (iii) disclose material facts about (a) its role, compensation and conflicts of interest, and (b) the broker-dealer or other third-party that the solicitor municipal advisor represents including, but not limited to, such party's disciplinary history. See MSRB Notice 2021-07 dated March 17, 2021, with a comment deadline of June 17, 2021, relating to draft MSRB 'Rule G-46 – Duties of Solicitor Municipal Advisors.' Comments to draft MSRB Rule G-46 were received from the following associations: (i) National Association of Municipal Advisors (NAMA), (ii) Securities Industry and Financial Markets Association (SIFMA), the leading trade association for broker-dealers, investment banks and asset managers operating in the US and global capital markets according to its website, and (iii) Third Party Marketers Association (3PM). NAMA recommends that MSRB require solicitor municipal advisors to disclose to the municipal entities they are soliciting, as well as conduit borrowers, that they do not have a fiduciary duty to them. SIFMA, among other things, suggests that a clear statement be made in the draft rule that 'solicitor municipal advisors do not owe a fiduciary duty to their clients and solicited entities.' In addition, SIFMA questions why representations made by a solicitor municipal advisor 'must be truthful and accurate' as it believes it is inconsistent with what non-solicitor municipal advisors must comply with.
Among 3PM's comments, it suggests that MSRB should not apply draft Rule G-46 to conduit borrowers, or provide guidance to solicitor municipal advisors that are also municipal advisor third-party solicitors working on behalf of third-party investment advisors.

[6] Since 2020, the following senior managers had resigned: Citigroup (Chief Executive Officer, Chief Compliance Officer and Chief Risk Officer), Credit Suisse (Chair, Chief Compliance Officer and Chief Risk Officer), Deutsche Bank (Chief Compliance Officer and Chief Risk Officer), Goldman Sachs (Chief Compliance Officer), HSBC (Chair, Chief Compliance Officer and Chief Risk Officer), Lloyds Bank (Chair), and Wells Fargo (Chief Compliance Officer and Chief Risk Officer). In addition, there were significant senior leadership changes announced at Bank of America in August/September 2021 including: (i) departures of Vice Chairman, Chief Operating Officer, and Head of Fixed Income, Currencies and Commodities Sales/CEO of BofA Securities Europe SA/Country Executive for France, with no replacements yet determined, (ii) departure of Global General Counsel with a replacement announced, (iii) internal position changes of Chief Financial Officer, Chief Administrative Officer, President of Global Commercial Bank and Business Banking, and President of Retail Banking, (iv) the split of the Chief Operations and Technology Officer role into two roles – Chief Technology and Information Officer, and Chief Operations Executive, and (v) new positions created for Global Compliance and Operational Risk, and Global Real Estate and Business Continuity.
Also in 2021 (i) JPMorgan Chase & Co. (a) announced the resignation of the Co-President and Chief Operating Officer, and (b) included as new members to its Operating Committee: the Global Head of Securities Services, Executive Chair of Investment Banking & Corporate Banking, and Head of Global Markets, and (ii) Mizuho Financial Group announced changes in senior management for the Group, Mizuho Bank and Mizuho Securities.

[7] According to Bond Dealers of America, it is the only trade association exclusively focused on U.S. fixed income markets and represents bond dealers headquartered in cities across the country.

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September 22, 2021

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