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SEC Risk Alert for Municipal Advisors Highlights Key Compliance Issues: Ballard Spahr

Summary

The Security and Exchange Commission last month released a Risk Alert to notify municipal advisors of key compliance issues. The SEC's Division of Examinations adds client disclosure concerns to the list of most frequently observed compliance failures. Additionally, the Division warns that it intends to have a sharper focus on core standards of conduct and duties required of municipal advisors.

The Upshot

- Municipal advisors are required to register with both the SEC and the Municipal Securities Rulemaking Board. The SEC requires municipal advisor firms to file Form MA as well as a Form MA-I for each natural person engaging in municipal advisory activities. The MSRB requires firms to file Form A-12 as well as to pay an initial and annual fee.
- Municipal advisors should ensure that policies and procedures are up to date and accurately reflect recordkeeping requirements for specific record types.
- Municipal advisors must establish a supervisory system reasonably designed to achieve compliance and, at a minimum, provide for the establishment, implementation, maintenance, and enforcement of written supervisory procedures.

The Bottom Line

The SEC's patience, even with small entities, can decrease after it has issued multiple alerts about a particular area of concern. Municipal advisors should review policies and procedures to avoid negative findings in future examinations.

On August 22, 2022, the SEC's Division of Examinations (the Division) released a [Risk Alert](#) to notify municipal advisors of key compliance issues. The alert follows the Division's [2017 release](#) and reiterates old concerns as well as raises new ones. While the 2017 release addressed deficiencies found in the areas of municipal advisor registration, recordkeeping, and supervision, this latest alert adds client disclosure concerns to the list of most frequently observed compliance failures. The Division warned that it intended to have a sharper focus on core standards of conduct and duties required of municipal advisors.

Filings and Fees

Prior to engaging in municipal advisory activities, municipal advisors are required to register with both the SEC and the Municipal Securities Rulemaking Board (MSRB). Registration with the SEC requires municipal advisor firms to file Form MA as well as a Form MA-I for each natural person associated with the municipal advisor who engages in municipal advisory activities. Registration with the MSRB requires firms to file Form A-12 as well as to pay an initial and annual fee. Forms MA and A-12 must be updated annually. In addition, all of the aforementioned registration forms must be updated promptly in the event of a material change to information previously provided, including

filing new Forms MA-I for newly associated persons and updating existing Forms MA-I to reflect any departing associated persons. The Division exam staff found that registration forms often were incomplete, inaccurate, and not updated to reflect changes or disclosures as required. Staff also found that some municipal advisors failed to properly pay the initial and annual MSRB registration fees.

Municipal advisors should conduct annual reviews of their filings to ensure accuracy and require associated persons to certify that their personal information is current. Policies and procedures should be updated, as needed, to inform associated persons of their duty to timely provide information on material changes. This annual review should be documented and can be incorporated into the required annual review of the municipal advisor's supervisory system under MSRB Rule G-44. Similarly, payment of filing fees and of the MSRB's annual municipal advisor professional fee under MSRB Rule A-11 should be reviewed annually.

Recordkeeping

[Exchange Act Rule 15Ba1-8](#) and [MSRB Rules G-8](#) and [G-9](#) impose various bookkeeping and record retention requirements with which municipal advisors' compliance was found to be lacking. Failure to maintain the following types of records were specifically noted:

- originals or copies of written communications relating to municipal advisory activities, particularly electronic communications including messages transmitted via personal email, text, and instant messenger;
- financial and accounting documents;
- records concerning compliance with MSRB Rule G-44, discussed below;
- written consents to service of process from associated persons;
- copies of documents created by the municipal advisor that were material to making a recommendation to a municipal entity or obligated person; and
- written agreements entered into by the municipal advisor with municipal entities and their employees, obligated persons, or otherwise relating to the municipal advisor's business.

Municipal advisors should ensure that policies and procedures are up to date and accurately reflect recordkeeping requirements for specific record types. Each item of required information should be easily located in a logical filing system and preserved in an appropriate manner in conformity with applicable MSRB and SEC record retention requirements. Testing and monitoring to ensure that records are correctly made, approved, and retained should be conducted, potentially as part of or in conjunction with the required annual review of the municipal advisor's supervisory system under MSRB Rule G-44.

Supervision

[MSRB Rule G-44](#) requires municipal advisors to establish a supervisory system reasonably designed to achieve compliance and, at a minimum, provides for:

- the establishment, implementation, maintenance, and enforcement of written supervisory procedures (WSPs) that are reasonably designed to achieve compliance with applicable rules; and
- the designation of one or more municipal advisory principals to be responsible for supervision.

Furthermore, municipal advisors must do the following:

- implement processes to establish, maintain, review, test and modify written compliance policies and WSPs and review such supervisory systems at least annually;

- designate a chief compliance officer; and
- have its chief executive officer (or equivalent) certify in writing annually to the presence of these supervisory requirements.

Division staff found that some municipal advisors did not have WSPs in place and, where they did exist, such written policies were ineffective to ensure compliance with applicable rules. The alert also noted that WSPs were often not amended to reflect rule changes, e.g., MSRB Rule G-42, which establishes duties of care and loyalty and governs conflicts of interest, and MSRB Rule G-40 regarding advertising, which became effective in 2019. Failures to test supervisory systems annually or perform chief executive officer certifications were also noted.

Municipal advisors should develop effective supervisory systems that include, among other things, principal supervision, systematic maintenance of approvals, and a process to monitor and implement regulatory change. That supervisory system should be specifically described in the firm's WSPs. On an annual basis, the chief compliance officer should conduct or oversee testing and monitoring of WSPs and produce a report to the chief executive officer to support the required annual certification under Rule G-44(d).

Client Disclosure

[MSRB Rule G-42](#) requires municipal advisors to provide their municipal entity or obligated person client with full and fair disclosure of all material conflicts of interest. Such disclosure must be made in writing and provide sufficient detail of the nature of the conflict, potential consequences, and how the municipal advisor will manage or mitigate each conflict. To the extent that a municipal advisor determines, following reasonable diligence, it has no known material conflicts, it must provide a written statement to that effect to the client. The municipal advisor must also maintain evidence of each municipal advisory relationship and update such documentation to reflect material changes.

Frequently cited deficiencies included a failure to disclose or to timely disclose conflicts of interest, for example, related to fee-splitting or contingent compensation arrangements. Municipal advisors also were cited for not providing a "no known material conflicts of interest" statement where applicable. Failures to adequately document client relationships also were found.

The client engagement process, which should encompass timely engagement documentation, including an accurate scope of services and any limitations thereto, as well as full and timely disclosure of conflicts, should also be covered in the municipal advisor's WSPs and be part of the annual compliance review and testing reporting process.

Core Duties and Standards of Conduct

While the Risk Alert did not delineate which of the core standards of conduct and duties required of municipal advisors it intends to focus more sharply upon in future examinations, the SEC's publicly announced enforcement activities and SEC staff statements at its annual outreach forums and in other venues can provide some sense of where staff priorities may lie. Substantive municipal advisor duties, beyond those described above, discussed during the three most recent joint SEC-MSR-FINRA compliance outreach programs for municipal advisors included documenting and fulfilling the municipal advisor's scope of services; potential municipal advisor duties during the new issue pricing process; role of municipal advisors in bank loans/direct placements; and the basis for the municipal advisor's own recommendations or its review of third-party recommendations. Recently filed SEC enforcement actions alleging breach of a municipal advisor's fiduciary duty involve duties with respect to the municipal advisor's role in disclosures in the offering document and the municipal advisor's participation in the preparation of allegedly fraudulent financial projections.

Municipal advisors should consider how they address these or similar scenarios in their WSPs and compliance policies.

Key Takeaways

Municipal advisors should note that the SEC's patience, even with small entities, can decrease when it has issued multiple alerts about a particular area of concern and should take this opportunity to review policies and procedures in order to avoid negative findings in future examinations. As a foundation, municipal advisors should focus on addressing the following questions for each area of concern:

- Who is responsible for compliance?
- How and where are supervisory systems documented?
- How is compliance with documented WSPs evidenced?
- How frequently is compliance tested and monitored?
- Have written supervisory procedures and compliance manual been updated to address these topics?

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