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MUNICIPAL ADVISORS - NEW YORK

Securities and Exchange Commission v. City of Rochester, New York

United States District Court, W.D. New York - April 15, 2024 - F.Supp.3d - 2024 WL 1621541

Securities and Exchange Commission (SEC) brought action against city's municipal advisor, its principals, and others for, among other things, failure to comply with Municipal Securities Rulemaking Board (MSRB) rules requiring municipal advisors to disclose material conflicts of interest and to establish, implement, and maintain written supervisory procedures, as well as breach of fiduciary duty and violation of Securities Exchange Act provision prohibiting municipal advisors from contravening MSRB rules.

SEC, advisor, and principals cross-moved for summary judgment as to liability on claims arising under MSRB rules.

The District Court held that:

- As a matter of apparent first impression, MSRB rule required advisor to disclose all contingency fee arrangements based on size or closing of a transaction;
- MSRB was authorized to depart from general securities-law definition of "materiality" in its disclosure rule;
- Disclosure rule was subject to rational review under First Amendment;
- Disclosure rule was reasonably related to legitimate government interest in regulating municipal securities market;
- As a matter of apparent first impression, negligence standard governed statutory and regulatory claims of a municipal advisor's breach of fiduciary duty to a municipal client;
- Advisor's email to clients inadequately disclosed conflicts of interest arising from contingency fee arrangements; and
- Failure to disclose conflicts of interest arising from contingency fee arrangements breached advisor's fiduciary duty of loyalty.

The unambiguous meaning of the Municipal Securities Rulemaking Board (MSRB) rule requiring a municipal advisor, "prior to or upon engaging in municipal advisory activities," to "provide to the municipal entity or obligated person client full and fair disclosure in writing of...all material conflicts of interest, including...any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice" is that conflicts of interest arising from contingency-fee arrangements based on the size or closing of the transaction are material conflicts of interest subject to mandatory disclosure.

The Municipal Securities Rulemaking Board (MSRB) rule requiring a municipal advisor, "prior to or upon engaging in municipal advisory activities," to "provide to the municipal entity or obligated person client full and fair disclosure in writing of...all material conflicts of interest, including...any

conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice” does not vest the municipal advisor with discretion to determine whether a contingency arrangement based on the size or closing of a transaction creates a material conflict of interest.

When fulfilling its congressional mandate to “provide professional standards” for municipal advisors and prescribe “means reasonably designed to prevent acts, practices, and courses of business” inconsistent with their fiduciary duties, Municipal Securities Rulemaking Board (MSRB) had authority to deem certain fee arrangements as presenting material conflicts of interest as a matter of law in its rule requiring municipal advisors to disclose all material conflicts of interest, even though federal securities laws generally treated materiality as mixed question of law and fact; deeming certain conflicts “material” was consistent with MSRB’s mandate, and nothing in Exchange Act required MSRB to adopt general securities-law definition of materiality. Securities Exchange Act of 1934 § 15B.

The materiality of a municipal advisor’s contingent fee arrangement, for purposes of the Municipal Securities Rulemaking Board (MSRB) rule requiring advisors to disclose all material conflicts of interest including “any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice,” is not measured by whether a fee is material to the municipal advisor; rather, materiality is evaluated through the viewpoint of the municipal clients, whom the rule is meant to protect.

In imposing a fiduciary duty on investment advisers through the Investment Advisers Act of 1940, Congress created both an affirmative obligation to employ reasonable care to avoid misleading clients and an affirmative duty of utmost good faith; thus, investment advisers must tell their clients about all conflicts of interest which might incline an investment adviser, consciously or unconsciously, to render advice which is not disinterested. Investment Advisers Act of 1940 § 206.

Municipal Securities Rulemaking Board (MSRB) rule requiring municipal advisors to disclose all material conflicts of interest including “any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice” was informational disclosure rule, and thus, district court would apply rational review to determine whether rule comported with First Amendment; rule only required disclosure of factual, uncontroversial information about an advisor’s own products and services, and rule did not limit what advisors could say in defense of contingency fee arrangements or prevent them from offering their opinions concerning any potential conflicts.

Municipal Securities Rulemaking Board (MSRB) rule requiring municipal advisors to disclose all material conflicts of interest including “any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice” was reasonably related to legitimate government interest in regulating municipal securities market, as necessary for such information disclosure rule to comport with First Amendment free speech principles; MSRB determined that mandatory disclosure of conflicts of interest inherent in contingency fee arrangements would protect municipal entity clients by allowing them to better evaluate advisors’ advice and whether such advice might be colored by conflicts.

Municipal Securities Rulemaking Board (MSRB) rule requiring municipal advisors to disclose all material conflicts of interest including “any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice,” which was intended to protect

municipal entity and obligated person clients, did not unduly burden speech, and thus, such information disclosure rule comported with First Amendment free speech principles; advisors were free to make clear that information disclosed represented MSRB's views and to tell clients why, in their view, contingency nature of fee arrangements would not impact advice given or otherwise harm their clients.

Municipal Securities Rulemaking Board (MSRB) rule requiring municipal advisors to disclose all material conflicts of interest including "any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice" provided a person of ordinary intelligence a reasonable opportunity to know what conduct was required, and thus, rule comported with due process; rule unambiguously required disclosure of all material conflicts of interest and defined certain contingency agreements as posing material conflicts of interest as matter of law, and Securities and Exchange Commission (SEC) issued guidance on contingency-fee-related conflicts subject to disclosure.

Where the Securities and Exchange Commission (SEC) has, through its regulations, written guidance, litigation, or other actions, provided a reasonable person operating within the defendant's industry fair notice that their conduct may prompt an enforcement action by the SEC, it has satisfied its obligations against vagueness under the Due Process Clause.

Written supervisory procedures that municipal advisor implemented during specified time period were not reasonably designed to ensure that municipal advisory activities of advisor and its associated persons were in compliance with Municipal Securities Rulemaking Board (MSRB) rule requiring municipal advisors to disclose all material conflicts of interest, and thus, such procedures violated MSRB rule requiring municipal advisors to establish, implement, and maintain written supervisory procedures that were reasonably designed to ensure such conduct was in compliance with applicable MSRB rules, even if advisor monitored employees' outside business activities for conflicts; documents did not address conflicts of interest at all, and monitoring did not constitute written supervisory procedure.

The standard for determining whether a municipal advisor has breached a fiduciary duty owed to a municipal client under the Exchange Act and the Municipal Securities Rulemaking Board (MSRB) rule governing the fiduciary relationship between municipal advisors and their clients is the same negligence standard applied under the Investment Advisers Act. Securities Exchange Act of 1934 § 15B, 15 U.S.C.A. § 78o-4(c)(1); Investment Advisers Act of 1940 § 201, 15 U.S.C.A. § 80b-1 et seq.

Email that municipal advisor sent clients, which stated advisor "may have conflicts of interest arising from compensation for municipal activities to be performed that are contingent on the size or closing of such transaction...if [advisor] should fail to get paid for its work on a transaction in the event that the transaction does not close," did not satisfy Municipal Securities Rulemaking Board (MSRB) rule requiring advisor to disclose, before or upon engaging in municipal advisory activities, any conflicts of interest arising from contingency fee arrangements based on size or closing of a transaction; single email over six-year period was not sent at beginning of activities and suggested that only potential conflict was if advisor ultimately was not paid for its work, without disclosing conflicts were inherent to such arrangements.

Municipal advisor's failure to inform each municipal client, prior to or upon engaging in municipal advisory activities, each actual or potential conflict of interest that was inherently created by its contingent fee arrangements based on size or closing of transactions, which failed to satisfy Municipal Securities Rulemaking Board (MSRB) rule requiring disclosure of any material conflict of interest including any such fee arrangement, breached advisor's fiduciary duty of loyalty under

Exchange Act and MSRB rules, even if advisor disclosed all forms of compensation it received in connection with any sales of debt securities and even if neither advisor nor its employees received any financial benefit from any other person. Securities Exchange Act of 1934 § 15B, 15 U.S.C.A. § 78o-4(c)(1).

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