MSRB NOTICE 2011-10 (FEBRUARY 9, 2011)

PROPOSED RULE AMENDMENTS AND INTERPRETIVE NOTICE FILED REGARDING RULE G-23 ON ACTIVITIES OF FINANCIAL ADVISORS

On February 9, 2011, the Municipal Securities Rulemaking Board (“Board” or “MSRB”) filed with the Securities and Exchange Commission (“SEC”) a proposed rule change (the “proposed rule change”) consisting of (i) proposed amendments to MSRB Rule G-23 (on activities of financial advisors) (the “proposed amendments”) and (ii) a proposed interpretation of Rule G-23 (the “proposed interpretive notice”).[[1]](http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-10.aspx" \l "_ftn1)

The MSRB has requested that the proposed rule change be made effective for new issues for which the Time of Formal Award (as defined in MSRB Rule G-34(a)(ii)(C)(1)(a)) occurs more than six (6) months after SEC approval to allow issuers of municipal securities time to finalize any outstanding transactions that might be affected by the proposed rule change.

**BACKGROUND**

Currently MSRB Rule G-23, on activities of financial advisors, sets forth the circumstances under which a broker, dealer, or municipal securities dealer (“dealer”) acting as a financial advisor to an issuer with respect to a new issue or issues of municipal securities (“dealer financial advisor”) may acquire all or any portion of such issue, directly or indirectly, from the issuer as a principal, or may act as agent for the issuer in arranging the placement of such issue, either alone or as a participant in a syndicate or other similar account formed for that purpose.  For negotiated transactions, Rule G-23(d)(i) requires that: (i) the dealer terminate the financial advisory relationship with regard to the issue and at or after such termination the issuer expressly consent in writing to such acquisition or participation by the dealer; (ii) at or before such termination, the dealer disclose in writing to the issuer that there may be a conflict of interest in changing from the capacity of financial advisor to that of purchaser of, or placement agent for, the securities and the issuer expressly acknowledge in writing to the dealer receipt of such disclosure; and (iii) at or before such termination, the dealer disclose in writing to the issuer the source and anticipated amount of all remuneration to the dealer with respect to such issue and the issuer expressly acknowledge in writing to the dealer receipt of such disclosure.  With respect to issues sold by competitive bid, Rule G-23(d)(ii) provides that a financial advisor must obtain the issuer’s written consent prior to making a bid for the issue.

The limitations of Rule G-23(d) also apply to affiliates of the dealer financial advisor; however, they do not apply to purchases by dealer financial advisors of securities from an underwriter, either for the account of the dealer financial advisor or for the account of customers of the dealer financial advisor, except to the extent that such purchases are made to contravene the purpose and intent of the rule.

In addition, Rule G-23(e) provides that a dealer that has a financial advisory relationship with respect to a new issue of municipal securities may not act as agent of the issuer in remarketing such issue unless the dealer has disclosed in writing to the issuer: (i) that there may be a conflict of interest in acting as both financial advisor and remarketing agent for the securities; and (ii) the source and basis of the remuneration the dealer could earn as remarketing agent on such issue.  The dealer must receive from the issuer its express acknowledgement, in writing, of its receipt of such disclosure and its consent to the financial advisor acting in both capacities along with the source and basis of remuneration.

**SUMMARY OF PROPOSED RULE CHANGE**

The proposed amendments would, subject to the exceptions described below, (i) prohibit a dealer financial advisor with respect to the issuance of municipal securities from acquiring all or any portion of such issue directly or indirectly, from the issuer as principal, or acting as agent for the issuer in arranging the placement of such issue, either alone or as a participant in a syndicate or other similar account formed for that purpose; (ii) apply the same prohibition to any dealer controlling, controlled by, or under common control with the dealer financial advisor; and (iii) prohibit a dealer financial advisor from acting as the remarketing agent for such issue.

The proposed amendments would not prohibit: (i) a dealer financial advisor from placing an issuer’s entire issue with another governmental entity, such as a bond bank, as part of a plan of financing by such entity for or on behalf of the dealer financial advisor’s issuer client;[[2]](http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-10.aspx" \l "_ftn2) (ii) a dealer financial advisor from serving as successor remarketing agent to an issuer for the same issue with respect to which it provided financial advisory services if the financial advisory relationship with the issuer had been terminated for at least one (1) year; or (iii) a dealer financial advisor from purchasing such securities from an underwriter, either for its own trading account or for the account of its customers, except to the extent that such purchase was made to contravene the purpose and intent of the rule.

The proposed amendments would change references in Rule G-23 to “a new issue or issues of municipal securities” to “the issuance of municipal securities” to conform the language of the rule to the language used in Section 15B of the Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).  This change in language is not intended to change the meaning or operation of Rule G-23.

The proposed amendments would also amend Rule G-23(b) to remove the requirement that financial advisory services be provided for compensation.  This change is proposed to conform the rule to the provisions of Section 15B of the Act, as amended by Dodd-Frank, which does not require that financial advisors receive compensation in order to be considered “municipal advisors.”  However, the proposed amendments would not amend the provisions of Rule G-23(b) that provide that a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a dealer renders advice to an issuer, including advice with respect to the structure, timing, terms, and other similar matters concerning the issuance of municipal securities.

The proposed interpretive notice would provide guidance on when a dealer that provides advice to an issuer would be considered to be “acting as an underwriter” for purposes of Rule G-23(b), rather than a financial advisor.  Under the proposed guidance, a dealer providing advice to an issuer with respect to the issuance of municipal securities (including the structure, timing, and terms of the issue and other similar matters, such as the investment of bond proceeds, a municipal derivative, or other matters integrally related to the issue) generally would not be viewed as a financial advisor for purposes of Rule G-23, if such advice is rendered in its capacity as underwriter for such issue and the dealer clearly identifies itself as an underwriter from the earliest stages of its relationship with the issuer with respect to that issue.  Nevertheless, a dealer’s subsequent course of conduct (*e.g*., representing to the issuer that it is acting only in the issuer’s best interests, rather than as an arm’s length counterparty, with respect to that issue) could cause the dealer to be considered a financial advisor with respect to such issue and such dealer would be precluded from underwriting that issue by Rule G-23(d).

The proposed rule change resulted from the Board’s concern that a dealer financial advisor’s ability to underwrite the same issue or issues of municipal securities, on which it acted as financial advisor, presents a conflict that is too significant for the existing disclosure and consent provisions of Rule G-23 to cure. Even in the case of a competitive underwriting, the perception on the part of issuers and investors that such a conflict might exist was sufficient to cause concern that permitting such role switching was not consistent with “a free and open market in municipal securities,” which the Board is mandated to perfect. The imposition by Dodd-Frank of a fiduciary duty upon municipal advisors,[[3]](http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-10.aspx" \l "_ftn3) which includes financial advisors, made the existence of such a conflict a greater concern.

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Questions about the proposed rule change should be directed to Peg Henry, Deputy General Counsel, or Leslie Carey, Associate General Counsel, at (703) 797-6600.

February 9, 2011

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**TEXT OF PROPOSED RULE CHANGE****[[4]](http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-10.aspx" \l "_ftn4)**

**Rule G-23: Activities of Financial Advisors**

(a) *Purpose*. The purpose and intent of this rule is to establish ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers with respect to the issuance of municipal securities.

(b) *Financial Advisory Relationship.* For purposes of this rule, a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to ~~a new issue or issues~~ the issuance of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such ~~issue or issues~~ issue. ~~for a fee or other compensation or in expectation of such compensation for the rendering of such services. Notwithstanding the foregoing~~ For purposes of this rule, a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning ~~a new issue~~ the issuance of municipal securities.

(c) *~~Basis of Compensation~~ Agreement with Respect to Financial Advisory Relationship*. Each financial advisory relationship shall be evidenced by a writing entered into prior to, upon or promptly after the inception of the financial advisory relationship (or promptly after the creation or selection of the issuer if the issuer does not exist or has not been determined at the time the relationship commences). Such writing shall set forth the basis of compensation, if any, for the financial advisory services to be rendered, including provisions relating to the deposit of funds with or the utilization of fiduciary or agency services offered by such broker, dealer, or municipal securities dealer or by a person controlling, controlled by, or under common control with such broker, dealer, or municipal securities dealer in connection with the rendering of such financial advisory services and shall be delivered to the issuer.

(d) *Prohibition on Engaging in Underwriting Activities*.

(i) Subject to provisions of subsections (d)(ii) and (iii), ~~N~~no broker, dealer, or municipal securities dealer that has a financial advisory relationship with respect to ~~a new issue~~ the issuance of municipal securities shall acquire as principal either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from the issuer all or any portion of such issue, or act as agent for the issuer in arranging the placement of such issue. ~~,unless~~

~~(i) if such issue is to be sold by the issuer on a negotiated basis,~~

~~(A) the financial advisory relationship with respect to such issue has been terminated in writing and at or after such termination the issuer has expressly consented in writing to such acquisition or participation, as principal or agent, in the purchase of the securities on a negotiated basis;~~

~~(B) the broker, dealer, or municipal securities dealer has expressly disclosed in writing to the issuer at or before such termination that there may be a conflict of interest in changing from the capacity of financial advisor to purchaser of or placement agent for the securities with respect to which the financial advisory relationship exists and the issuer has expressly acknowledged in writing to the broker, dealer, or municipal securities dealer receipt of such disclosure; and~~

~~(C) the broker, dealer, or municipal securities dealer has expressly disclosed in writing to the issuer at or before such termination the source and anticipated amount of all remuneration to the broker, dealer, or municipal securities dealer with respect to such issue in addition to the compensation referred to in section (c) of this rule, and the issuer has expressly acknowledged in writing to the broker, dealer, or municipal securities dealer receipt of such disclosure; or~~

~~(ii) if such issue is to be sold by the issuer at competitive bid, the issuer has expressly consented in writing prior to the bid to such acquisition or participation.~~

(ii) Notwithstanding subsection (d)(i), a broker, dealer or municipal securities dealer that has a financial advisory relationship with respect to the issuance of municipal securities shall not be prohibited from acting as agent for the issuer in arranging the placement of the entire issue with any state, local or federal governmental entity as part of a plan of financing by such entity for or on behalf of the issuer, but only if such broker, dealer or municipal securities dealer does not receive compensation from any person other than with respect to financial advisory services related to such placement and does not receive compensation from any person for underwriting any contemporaneous financing transaction directly or indirectly related to such issue undertaken by the state, local or federal governmental entity with which such issue was placed.

(iii) The limitations ~~and requirements~~ set forth in this section (d) shall also apply to any broker, dealer, or municipal securities dealer controlling, controlled by, or under common control with the broker, dealer, or municipal securities dealer having a financial advisory relationship with respect to the issuance of municipal securities.  The use of the term "indirectly" in this section (d) shall not preclude a broker, dealer, or municipal securities dealer that ~~who~~ has a financial advisory relationship with respect to ~~a new issue~~ the issuance of municipal securities from purchasing such securities from an underwriter, either for its own trading account or for the account of customers, except to the extent that such purchase is made to contravene the purpose and intent of this rule.

(e) *Remarketing Activities.* No broker, dealer, or municipal securities dealer that has a financial advisory relationship with an issuer with respect to ~~a new issue~~ the issuance of municipal securities shall act as the remarketing agent for such issue; provided, however, that this section shall not prohibit such broker, dealer or municipal securities dealer from thereafter serving as successor remarketing agent for such issue if the financial advisory relationship in connection with such issue has been terminated for a period of at least one (1) year prior to such broker, dealer or municipal securities dealer being selected to serve as successor remarketing agent. ~~,unless the broker, dealer, or municipal securities dealer has expressly disclosed in writing to the issuer:~~

~~(i) that there may be a conflict of interest in acting as both financial advisor and remarketing agent for the securities with respect to which the financial advisory relationship exists; and~~

~~(ii) the source and basis of the remuneration the broker, dealer or municipal securities dealer could earn as remarketing agent on such issue.~~

~~This written disclosure to the issuer may be included either in a separate writing provided to the issuer prior to the execution of the remarketing agreement or in the remarketing agreement. The issuer must expressly acknowledge in writing to the broker, dealer, or municipal securities dealer receipt of such disclosure and consent to the financial advisor acting in both capacities and to the source and basis of the remuneration.~~

~~(f)~~ *~~Disclosure to Issuer of Corporate Affiliation~~*~~. If the financial advisor for the issue is not a broker, dealer or municipal securities dealer, and the broker, dealer or municipal securities dealer that acquires the issue or arranges for such acquisition pursuant to section (d) of this rule is controlling, controlled by, or under common control with such financial advisor, the broker, dealer or municipal securities dealer must disclose this affiliation in writing to the issuer prior to the acquisition and the issuer has expressly acknowledged in writing to the broker, dealer, or municipal securities dealer receipts of such disclosure.~~

~~(g) Each broker, dealer, and municipal securities dealer subject to the provisions of sections (d), (e) or (f) of this rule shall maintain a copy of the written disclosures, acknowledgments and consents required by these sections in a separate file and in accordance with the provisions of rule G-9.~~

(~~h)~~ *~~Disclosure to Customers~~*~~. If a broker, dealer, or municipal securities dealer acquires new issue municipal securities or participates in a syndicate or other account that acquires new issue municipal securities in accordance with section (d) of this rule, such broker, dealer, or municipal securities dealer shall disclose the existence of the financial advisory relationship in writing to each customer who purchases such securities from such broker, dealer, or municipal securities dealer, at or before the completion of the transaction with the customer.~~

(f) ~~(i)~~ *Applicability of State or Local Law*. Nothing contained in this rule shall be deemed to supersede any more restrictive provision of state or local law applicable to the activities of financial advisors.

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**Guidance on the Prohibition on Underwriting Issues of Municipal Securities for Which a Financial Advisory Relationship Exists Under Rule G-23**

MSRB Rule G-23 establishes certain basic requirements applicable to a broker, dealer, or municipal securities dealer (“dealer”) acting as a financial advisor with respect to the issuance of municipal securities.  MSRB Rule G-23(d) provides that a dealer that has a financial advisory relationship with respect to the issuance of municipal securities is precluded from acquiring all or any portion of such issue, directly or indirectly, from the issuer as principal, either alone or as a participant in a syndicate or other similar account formed for that purpose.  A dealer is also precluded from arranging the placement of an issue with respect to which it has a financial advisory relationship.  This notice refers to both of these activities as “underwritings” and provides interpretive guidance on when a dealer may be precluded by Rule G-23(d) from underwriting an issue of municipal securities due to having served as financial advisor with respect to that issue.

Rule G-23(b) provides, among other things, that a financial advisory relationship shall be deemed to exist for purposes of Rule G-23 when a dealer provides or enters into an agreement to provide financial advisory or consultant services to or on behalf of an issuer with respect to the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such issue or issues.   Rule G-23(b) also provides, however, that a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter, a dealer provides advice to an issuer, including advice with respect to the structure, timing, terms, and other similar matters concerning the issuance of municipal securities.

For purposes of Rule G-23, a dealer that provides advice to an issuer with respect to the issuance of municipal securities will be presumed to be a financial advisor with respect to that issue.  However, that presumption may be rebutted if the dealer clearly identifies itself as an underwriter from the earliest stages of its relationship with the issuer with respect to that issue. Thus, a dealer providing advice to an issuer with respect to the issuance of municipal securities (including the structure, timing, and terms of the issue and other similar matters, such as the investment of bond proceeds, a municipal derivative, or other matters integrally related to the issue) generally will not be viewed as a financial advisor for purposes of Rule G-23, if such advice is rendered in its capacity as underwriter for such issue.  Nevertheless, a dealer’s subsequent course of conduct (*e.g*., representing to the issuer that it is acting only in the issuer’s best interests, rather than as an arm’s length counterparty, with respect to that issue) may cause the dealer to be considered a financial advisor with respect to such issue.  In that case, the dealer will be precluded from underwriting that issue by Rule G-23(d).

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[[1]](http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-10.aspx" \l "_ftnref1) [File No. SR-MSRB-2011-03](http://www.msrb.org/msrb1/pdfs/SR-MSRB-2011-03.pdf).  Comments on the proposed rule change should be submitted to the SEC and should reference this file number.

[[2]](http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-10.aspx" \l "_ftnref2) The exception would only apply if the dealer financial advisor did not receive compensation for the placement of such issue and the dealer financial advisor was not compensated as an underwriter in connection with any related transaction undertaken by the governmental entity with which such issue is placed.

[[3]](http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-10.aspx" \l "_ftnref3) Dodd-Frank amended Section 15B(c)(1) of the Act of 1934 to provide that:

A municipal advisor and any person associated with such municipal advisor shall be deemed to have a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor, and no municipal advisor may engage in any act, practice, or course of business which is not consistent with a municipal advisor’s fiduciary duty or that is in contravention of any rule of the Board.

[[4]](http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-10.aspx" \l "_ftnref4) Underlining indicates additions; strikethroughs indicate deletions.