Guidance for Municipal Underwriters in Understanding Due Diligence Responsibilities in Competitively Bid Transactions

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The following is intended to provide municipal underwriting firms with some guidance in understanding due diligence responsibilities in competitively bid transactions. The United States Securities Exchange Commission (the "SEC") provided an extensive discussion of the responsibility of municipal underwriting firms to conduct due diligence in its 1988 interpretative release[1] (the "1988 Release"). Included in that discussion was an explanation of the SEC's interpretation of the due diligence responsibilities of municipal underwriters in competitively bid transactions. Competitively bid transactions present a challenge to municipal underwriters because they are not included in the process of reviewing or preparing the disclosure document and often times are not given adequate opportunities to discuss the disclosure with the issuer. The SEC itself acknowledged these difficulties in the 1988 Release. The SEC stated that:

> "…the Commission recognizes that municipal underwriters may have little initial access to background information concerning securities that have been bid on a competitive basis. Therefore, the fact that offerings are competitively bid, rather than sold through a negotiated offering, is an element to be considered in determining the reasonableness of the underwriters' basis for assessing the truthfulness of key representations in final official statements."

At the same time that the SEC recognized these difficulties, it also expressed in the 1988 Release considerable concern about the practices of municipal underwriters in competitively bid transactions. The SEC stated:

> "The Commission believes that the conduct of the underwriters in the [Washington Public Power] Supply System offerings, and the position advanced by some members of the industry, with respect to their responsibilities in competitively bid offerings, raise serious concerns that warrant additional review."

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[1] Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778. In the 1988 Release the SEC both published for comment the proposed Rule 15c2-12 and released interpretative guidance for the securities law responsibilities of municipal underwriters. The SEC published the 1988 Release and would ultimately promulgate Rule 15c2-12 in large part as a result of its conclusions that the issuer and municipal underwriters had not engaged in adequate securities disclosure practices in a series of bond offerings by the Washington Public Power Supply System.

In response to these concerns, the SEC laid out what it considered to be a reasonable approach for municipal underwriters to carry out their securities law responsibilities in competitively bid transactions.

> "The Commission believes that in a normal competitive bid offering, involving an established municipal issuer, a municipal underwriter generally would meet its obligation to have a reasonable basis for belief in the accuracy of the key representations in the official statement where it reviewed the official statement in a professional manner, and received from the issuer a detailed and credible explanation concerning any aspect of the official statement that appeared on its face, or on the basis of information available to the underwriter, to be inadequate. In reviewing the issuer's disclosure documents, therefore, underwriters bidding on competitive offerings should stay attuned to factors that suggest inaccuracies in the disclosure or signal that additional investigation is necessary. If these factors appear, the underwriter should investigate the questionable disclosure and, if a problem is uncovered, pursue the inquiry until satisfied that correct disclosure has been made."

Thus, in a competitive bid offering, the SEC expects the municipal underwriter to review the offering document and to conduct further inquiry only if the disclosures in the document raise concerns. The municipal underwriter must receive a credible explanation from the issuer or financial advisor that resolves the concerns In the end, if the municipal underwriter cannot confirm that the issuer has ensured adequate securities disclosure, then the SEC may call into question the reasonableness of the municipal underwriter's review. As the SEC states in the 1988 Release:

> "With respect to competitively bid offerings of municipal securities, members of the municipal securities industry have argued that the uncertainty of the bidding process and time pressures associated with these offerings make it difficult for underwriters to conduct an investigation of the issuer or its statements. The fact that an offering is underwritten on a competitive basis does not negate the responsibility that the underwriter perform a reasonable review."

In light of this, our guidance to municipal underwriters in understanding their due diligence responsibilities in competitively bid transaction is to review the relevant offering document and evaluate whether the disclosure suggests that there may be materially incomplete or inaccurate disclosure. If this arises, we recommend municipal underwriters to contact the issuer or the financial adviser to clarify these concerns. Ultimately, if a municipal underwriter encounters a material disclosure concern and neither the issuer nor the financial adviser can adequately resolve that concern, the municipal underwriter may need to abstain from participating in the transaction.