May 16, 2012

SEC Approves MSRB Interpretive Notice on Municipal Security Underwriters

The Securities and Exchange Commission has approved the Municipal Securities Rulemaking Board's Interpretive Notice concerning the application of MSRB's fair dealing rules – MSRB Rule G-17 – to municipal securities underwriters, which will become effective on **August 2, 2012**.[1] MSRB Rule G-17 requires brokers, dealers and municipal securities dealers to deal fairly in conducting their municipal securities activities and not to engage in any deceptive, dishonest or unfair practices. The Interpretive Notice will impose new specific obligations on municipal securities underwriters relating to their representations and disclosures to issuers, among other areas. Of particular note is a requirement that municipal securities underwriters provide particularized, written risk disclosures when recommending "complex municipal securities financings."

Scope of the Interpretive Guidance

The Interpretive Notice applies to underwriters' dealings with municipal entity issuers of municipal securities, and it does not address the duties of underwriters to other obligors. Except as noted below, the Interpretive Notice applies to negotiated underwritings and not to competitive underwritings and does not apply to selling group members.

Disclosures to Issuers

The Interpretive Notice requires underwriters to provide issuers with disclosures related to the underwriter's role and compensation, conflicts of interest and complex financings (as defined below):

	Disclosure regarding the underwriter's role and compensation	**Other disclosures regarding conflicts of interest**	**Disclosure regarding complex financings recommended by the underwriter**
What Must Be Disclosed?	Certain baseline disclosures, including: ▪ that the underwriter is required by MSRB Rule G-17 to deal fairly with municipal issuers and investors; ▪ that the underwriter's primary role is to purchase securities with a view to distribution and it has financial and other interests that differ from	All potential or actual material conflicts of interest, including: ▪ any payments to or from third parties (discussed in more detail below); ▪ any profit sharing arrangements with investors (discussed in more detail below); and	More particularized disclosures that are specific to the financing, including: ▪ all material financial characteristics of the complex municipal securities financing; ▪ all material financial risks that are known to the underwriter and reasonably foreseeable at the time of the disclosure; and ▪ any incentives the underwriter has to recommend the financing

[1] Order Approving Proposed Rule Change, as Modified by Amendment No. 2, Consisting of Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities, Exch. Act. Rel. No. 66927 (May 4, 2012), *available at* http://sec.gov/rules/sro/msrb/2012/34-66927.pdf.

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	those of the issuer; ▪ that the underwriter does not have a fiduciary duty to the issuer under the federal securities laws; ▪ that the underwriter must purchase securities from the issuer at a fair and reasonable price, but must also sell municipal securities to investors at fair and reasonable prices; and ▪ that the underwriter will review the official statement for the issuer's securities as part of its responsibilities to investors under the federal securities laws. In addition, the underwriter must: ▪ disclose to the issuer whether its compensation will be contingent on the closing or size of the transaction, and, if so, that this presents a conflict and may cause the underwriter to recommend a transaction that is unnecessary or to recommend that the size of the transaction be larger than necessary.	▪ the fact that the underwriter engages in credit default swaps ("**CDS**") activities for which the reference is the issuer. However, activities in CDS based on a basket or index of municipal issuers that includes the issuer need not be disclosed, unless the issuer represents more than 2% of the total notional amount of the CDS, or the underwriter caused the issuer to be included in the basket or index.	and any other associated conflicts of interest. The level of required disclosure may vary according to the underwriter's reasonable belief of the issuer's knowledge or experience with the proposed financing structure or similar structures, capability of evaluating the risks, and financial ability to bear the risks of the financing. However, the underwriter's conflicts and incentives must be disclosed in all cases. Although these requirements generally only apply to complex municipal securities financings, where the underwriter believes that issuer personnel lack knowledge or experience with a routine, generally well understood, plain vanilla financing structures, the underwriter must provide disclosures on the "material aspects of such structures that it recommends." Municipal securities underwriters will need to implement procedures for such assessment.

	Disclosure regarding the underwriter's role and compensation	Other disclosures regarding conflicts of interest	Disclosure regarding complex financings recommended by the underwriter
Disclosure Trigger and Timing	***Disclosure concerning the arm's-length nature of the underwriter-issuer relationship****:* When the underwriter responds to a Request for Proposal or provides promotional materials to the issuer. ***Disclosures concerning the role of the underwriter and the underwriter's compensation*****:** When the underwriter is engaged to perform underwriting services (*e.g.*, in an engagement letter) and not solely in a bond purchase agreement.	The earlier of the issuer's engagement of the underwriter, or the emergence of a conflict at any point after engagement.	When the underwriter recommends a "complex municipal securities financing," such as (i) variable rate demand obligations, (ii) derivatives (such as swaps), or (iii) unique, atypical, or otherwise complex structures.[2] Disclosures concerning complex municipal securities financing must be made in sufficient time before the execution of the contract to allow the issuer to evaluate the recommendation.
Manner of Disclosure	Disclosures must be in writing and the underwriter must attempt to receive written acknowledgement by the official of the issuer of the receipt of the disclosures. If the official of the issuer will not provide written acknowledgement of receipt, the underwriter may proceed with the engagement after documenting with specificity why it was unable to obtain an acknowledgement.	Same as column to the left.	The disclosure must be written, and discuss the specific elements of the financing rather than being general in nature.

[2] The definition of "complex municipal securities financing" appears to capture any municipal financing that has a derivative component, even if the structure is common and generally well understood by issuers.

	Disclosure regarding the underwriter's role and compensation	Other disclosures regarding conflicts of interest	Disclosure regarding complex financings recommended by the underwriter
To Whom Must Disclosure be Made?	An official of the municipal entity who, on the reasonable belief of the underwriter, has the authority to bind the municipal entity, and to the knowledge of the underwriter, is not a party to a disclosed conflict.	Same as the column to the left.	An official of the municipal entity who, on the reasonable belief of the underwriter, has the authority to bind the municipal entity by contract with the underwriter. The underwriter must assess whether the official to whom these disclosures are made is capable of independently evaluating the disclosures, and, if not, must make additional efforts to inform the official (or its employee or agent). The burden of assessing whether the official is capable of independently evaluating the disclosures is on the underwriter, and the underwriter must implement procedures to make this assessment.
Can a Person Other Than The Underwriter Make the Disclosure?	Disclosures concerning the role of the underwriter and the underwriter's compensation may be made by a syndicate manager on behalf of other syndicate members.	No.	Not specifically addressed in the Interpretive Notice.

In addition, the Interpretive Notice prohibits underwriters from recommending that the issuer not retain a municipal advisor.

Representations to Issuers

An underwriter must have a reasonable basis for all representations made to issuers. The representations, whether written or oral, must be truthful and accurate and must not misrepresent or omit material facts. A prospective underwriter's response to an issuer's request for proposal ("**RFP**") must fairly and accurately describe the underwriter's capacity, resources and knowledge to perform the underwriting at the time the RFP is submitted, and must not contain any information that the underwriter knows or should know to be inaccurate or misleading. Matters not within the personal knowledge of those preparing the RFP response (*e.g.*, pending litigation) must be confirmed with persons with knowledge of the subject matter.

Underwriter Duties in Connection with Issuer Disclosure Documents

An underwriter must have a reasonable basis for the representations that it makes, and other material information that it provides (such as anticipated cash flows) in connection with the preparation by the issuer of its disclosure documents.

Underwriter Compensation and New Issue Pricing

Excessive Compensation

The Interpretive Notice explains that an underwriter's compensation for a new issue could be so disproportionate to the nature of the underwriting and the services performed as to constitute an unfair practice in violation of Rule G-17. In addition to the nature of the underwriting and the services performed, the underwriter should consider the following factors in determining whether compensation is excessive: (i) the credit quality of the issuer; (ii) the size of the issue; (iii) market conditions; (iv) the length of time spent structuring the issue; and (v) whether the underwriter is paying the underwriter's legal fees or any other relevant costs of the financing.

Fair Pricing

The Interpretive Notice states that an underwriter implicitly represents to the issuer that the pricing of the issue is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value of the issue at the time of pricing. This duty of fair dealing is satisfied in a competitive underwriting as long as the underwriter has submitted a "bona fide bid"[3] that is based on the dealer's best judgment of the fair market value of the issuance. In a negotiated underwriting, the underwriter has a duty to negotiate in good faith with the issuer and to ensure the accuracy of all representations made during the course of negotiations, including representations regarding the price negotiated and the nature of investor demand for the securities.

Conflicts of Interest

Payments to or from Third Parties

Under the Interpretive Notice, an underwriter's duty of fair dealing requires it to disclose to the municipal issuer any payment received by the underwriter from third parties, including affiliated parties, in connection with the underwriting, and any payments made by the underwriter to third parties in connection with the underwriting, as well as any details of any "third-party arrangements for the marketing of the issuer's securities." In response to comments, the final Interpretive Notice was amended to allow the underwriter to not disclose the amount of third-party payments.

Profit-Sharing with Investors

Depending on the facts and circumstances, it would be a violation of the underwriter's duty of fair dealing to enter into an arrangement under which it shares in an investor's profits earned on the resale of securities.

Retail Order Periods

The Interpretive Notice interprets an underwriter's duty of fair dealing to include an obligation to honor any agreement with an issuer as to retail order period directions, unless it receives the issuer's consent to deviate from the issuer's requirements. In this regard, the Interpretive Notice requires an underwriter to take reasonable measures to ensure that retail clients are bona fide.

[3] Under MSRB Rule G-13, a quotation shall be deemed to represent a "bona fide bid for, or offer of, municipal securities" if the broker, dealer or municipal securities dealer making the quotation is prepared to purchase or sell the security that is the subject of the quotation at the price stated in the quotation and under such conditions, if any, as are specified at the time the quotation is made.

Dissenting Statement

Certain aspects of the Interpretive Notice – particularly the written risk disclosure requirements – have been highly controversial, and drew criticism from some industry commentators. SEC Commissioners Gallagher and Paredes dissented from the agency's approval order, and in their joint dissent expressed the view that neither the MSRB nor the Commission adequately considered the potential adverse effects of the regulatory uncertainty that could result from the imprecise and ambiguous nature of the MSRB's guidance. Pointing to the vagueness of key concepts such as "complex" or "atypical" financing, Commissioners Gallagher and Paredes argued that such undefined terms and concepts could potentially lead to a more costly and less efficient underwriting process.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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