MAGIS ADVISORS
public finance consulting

September 14, 2012
Mr. Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, VA 22314

Re: MSRB Notice 2012-43 dated August 15, 2012 — "Request for Comment: Rule G-37 on Political Contributions and Prohibitions on Municipal Securities Business—Bond Ballot Campaign Committee Contributions"

Ladies and Gentlemen:

On behalf of Magis Advisors, I thank you for the opportunity to offer comments on the above matter. The integrity of the municipal securities market has never been more important than it is at this challenging time. The lingering effects of the Great Recession, the astounding developments of several of America's cities entering bankruptcy protection, and the spectacle of city managers being placed under arrest for unethical behavior, all represent a serious challenge to the confidence of investors who supply the capital funds to America's public agencies.

The Board's recent activities with respect to implementation of the provisions of the Dodd-Frank Act are all clearly designed to bolster the integrity of the market. This Release is but another important step in that direction, and the Board is to be congratulated for having the courage to take on this issue.

The comments herein are offered from the perspective of a municipal advisor with more than forty years of experience in the municipal markets, the majority of which has been as a municipal advisor, but a significant portion of which was devoted to the sales and trading of municipal securities. Despite the scope of the lack of applicability of the Notice to municipal advisors because of the unfortunate delay in defining exactly what a "municipal advisor" is, we nevertheless encourage the Board to continue its rulemaking and discussion in this respect. Our expectation is that once the definition of a municipal advisor has been settled, then the precedent for the applicability of the Notice to such advisors will likely have been established through this process.

The Securities and Exchange Commission, and the Board, have long acknowledged that many issuers of municipal securities are small, irregular visitors to the capital markets and are deserving of the protections afforded to such participants as a matter of fairness. Improving the transparency of the economic forces that affect the decisions of these agencies contributes to that fairness and is an important part of overall market integrity.

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As a matter of principle and common sense, Magis is strongly opposed to any circumstance where any market professional is permitted to directly, or indirectly, contribute to bond campaigns that serve the interests of such a participant, often at the expense of the local agency. This is due to simple logic: In such decisions, it is the electorate that is the decision-making body, not the City Council, Board of Directors or the Board of Education. If the tax-paying public is being asked to accept the burden of long-term debt—debt that will produce meaningful fee income to those who recommend, structure and sell it—then the public has the right to be told of the potential for economic gain to those who would influence or recommend the transaction to them. And, the market participant should embrace the idea of such a disclosure, because it is in the best interest of the client, promotes better government, and bolsters the integrity of the market—a market built on confidence.

In our state, for example, this has significant precedent. In an opinion in 2003, the California Legislative Counsel's Office stated, in relevant part that "…it is our opinion that a school district or other local agency may not condition the award of an agreement to provide bond underwriting services on the underwriter also providing campaign services in support of that bond measure or another bond measure proposed by the school district or other local agency."

That precedent seems to have produced a particularly worrisome effect since then. It now appears that underwriters are contributing to school bond election campaigns that are being run by municipal advisors or that the municipal advisor is responsible for taking an advocacy position. Despite some persons characterizing these activities as being "helpful," or "demonstrating commitment to the client's outcome," they are highly dangerous and, in our view, destructive of the objective requirements of the public's trust. First, such activities are in direct violation of state law. California law prohibits the expenditure of public monies on electioneering. Compensating a municipal advisor for activities that *per se* establish the very conflicts that the Board is attempting to address is at the heart of the problem. Second, if municipal advisors wish to be independent, and properly fulfill their fiduciary obligation to the client, it confounds us how that can happen effectively when the municipal advisor knowingly participates in a commercial arrangement that creates a conflict that is both material and undisclosed and which places the advisor's motive to fulfill that duty in doubt.

It is also an unfortunate fact that the idiosyncratic nature of the municipal bond market makes comparison of one school district's bond issue to another exceedingly difficult. The result of this phenomenon is that well-intentioned local government officials have few tools available to them to do due diligence on the essential differences between their service providers. An underwriter or other financial market professional who has made a significant investment of time and effort in promoting or inducing a positive outcome on a bond campaign and who is working on a contingent fee basis has a significant interest in the issuance of the bonds, whether burdening the agency's stakeholders further is a good idea or not.

The concerns I am raising here, and the concerns being addressed by the Notice, are by no means a recent phenomenon. In 1996 for example, the Government Finance Officers Association, the National League of Cities, the National Association of Counties, and other similar organizations, with input from the Securities and Exchange Commission, published an important pamphlet entitled "Questions to Ask

Before You Approve a Bond Issue." In that pamphlet there are two specific recommendations offered to officials in the position to approve a bond issue. The first recommendation asks: "What policies and procedures have we [the agency] developed to determine whether material conflicts of interest exist that need to be disclosed?" In addition, the second recommends that officials should ask outside professionals the following question, among others: "Are there any matters regarding your participation in this transaction about which you should make us aware, including potential conflicts of interest?"

Underwriters and other advisors who seek to guide the decision making process of local agencies enjoy a unique "trust relationship" with those agencies. That relationship must be carefully managed lest it deteriorate into an opportunity for fraud or deceit. In 1963, the United States Supreme Court issued an opinion in the matter of SEC v. Capital Gains Research Bureau that stated, in relevant part, "…failure to disclose material facts must be deemed fraud or deceit within its intended meaning, for, as the experience of the 1920s and 1930s amply reveals, the darkness and ignorance of commercial secrecy are the conditions under which predatory practices best thrive." Undisclosed conflicts of interest must be assumed to be material if, in fact, the beneficiary of such a conflict seeks to avoid its disclosure. If such conflicts are buried in the darkness and ignorance of commercial secrecy, then it follows that a fertile climate for predatory practices may be cultivated, even in 2012.

Broker – dealers acting as underwriters should be presumed to be serving their self interests by recommending financing strategies and bond products that will produce greater compensation to them, so long as the suitability requirement for the customer is being met. This also presumes, of course, that the customer (in this case, the public agency) is sufficiently grounded and knowledgeable about the recommendation to discern the presence of a conflict of interest that might be driving the recommendation. That is clearly not the case in the current situation.

The nature of these conflicts of interest has clear adverse effects on the issuer. These adverse effects are both well recognized and well documented in the financial community. For example, the American Institute of Certified Public Accountants publishes the *AICPA Audit Committee Toolkit* that, among other things, provides specific tools tailored for <u>governmental</u> organizations to identify and manage potential conflicts of interest. A common theme in conflict of interest policies developed by nonprofits and local governments is the concept of an "interested person." Moreover these conflict of interest policies typically define a "material financial interest," as an interest of any kind which, in view of all the circumstances, is substantial enough that it would, or reasonably could, affect the interested person's judgment with respect to the transaction in which it is a party. There can be little doubt that a municipal bond underwriter, or any other municipal market participant who stands to gain from the payment of a contingent fee, meets the definition of an interested person. That is why it is critical that the Board focus its attention on this matter.

We are also concerned that existing G-37 submissions by underwriters occur only quarterly and are exceedingly difficult to search by issuer name because the records are "dealer name-centric." We would strongly encourage the Board to consider a disclosure system that would require more timely disclosure of these conflicts of interest prior to the bond election so that the decision-makers—the

electorate—can have all of the facts necessary to consider whether or not the financial interest is material enough that it reasonably could affect the judgment of the professionals engaged to complete the transaction. The ability to access the data by state or type of issuer would help immensely.

Finally, we are also concerned that there may be compelling reasons to require that disclosure of potential conflicts of interest also be made in official statements in order to avoid introducing error or omission to the issuer's official statement. If so, this would serve the additional purpose of placing the issuer, the investor, and other market participants on notice that there are, or may have been, material financial interests that influenced the judgment of the market professionals who structured and sold the bond issue.

We applaud the Board's direction and focus. We support that direction and focus. We await the positive outcomes that will be produced as a result of this proposed rulemaking.

Very truly yours,

MAGIS ADVISORS

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