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August 19, 2019

Municipal Securities Rulemaking Board  
1300 I Street, NW  
Washington, DC 20005

Attention: Mr. Ronald W. Smith  
Corporate Secretary

***Re: Comments on MSRB Rule G-23 and Rule G-42—Activities of Municipal Advisors***

Ladies and Gentlemen:

I am submitting these comments as requested by the Municipal Securities Rulemaking Board (MSRB or Board) in its Notice 2019-13, *Request for Comment on MSRB Rule G-23 on Activities of Dealers Acting as Financial Advisors* (May 20, 2019).

Thank you for this opportunity. I appreciate it. The subject matter presents critical and pivotal crossroads regarding whether the important protections for municipal bond issuers that the Dodd-Frank Act was intended to provide will be diluted significantly.

The Board's review of Rule G-42, especially in the context of Rule G-23's conflict of interest provisions, offers an opportunity also for a careful consideration of Rule G-42's conflict of interest provisions and selected other provisions in general. Among other issues, the review of Rule G-23 and Rule G-42 offers the opportunity to consider whether dealer municipal advisors should be able to bid in the same competitive bond offerings in which the dealer advisors provide advice to their clients. As discussed in this letter, I oppose such bidding as offering excessive opportunities for abuse without the benefit of purported benefits. It would represent a substantial backward step from the positive action taken by the Board in 2011 to prohibit completely financial advisors from serving as underwriters and placement agents.

The Board's review also presents an opportunity to consider carefully within the context of Rules G-23 and G-42 requests by municipal advisors for regulatory permission to engage in activities commonly considered to fall within the purview of dealers, as underwriters and placement agents. Such activities include, when securities are involved, identifying and soliciting investors other than through the traditional competitive bid process, selling bonds directly to investors through negotiation, and negotiating bond terms in direct discussions with investors. At the same time, municipal advisors may be receiving compensation contingent upon completion

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of the bond sales, a form of payment typically associated with underwriters and placement agents.

If not delineated appropriately, any such regulatory permission would risk turning municipal advisors away from the focus of providing sound and unbiased advice regarding *whether* bonds should be issued and sold. Instead, municipal advisors could become financial firms working virtually “in-house” for issuer and obligated person clients primarily interested in closing transactions in order to collect contingent compensation. Such a misplaced focus would defeat the goals of the Dodd-Frank Act to provide municipal entities and obligated persons with access to “advisors” who are dedicated to serve solely in the best interests of their clients, as opposed to just another form of bond sales personnel.

In my litigation consulting activities, I have seen claims that an advisor need only assist an issuer in selling bonds, without responsibility to warn the issuer about serious transactional risks. Such attitudes defeat the purpose of issuer retention of municipal advisors.

In essence, if municipal advisors wish to serve in dealer capacities, they should register as dealers and accept their responsibilities under Rule G-23 and otherwise. If they persist in declining to register, Rule G-23 and other rules applicable to dealers should be enforced against them anyway.

In addition, as discussed in this letter, experience with real life municipal advisor activities demonstrate that conflicts of interest are much more varied, common and serious than identified at the time Rule G-42 was first conceived and also when Rule G-23 was first adopted in the early days of the Board’s activities and then was amended in 2011.

I hope that my comments stimulate a review not only of Rule G-23 and the sound principles underlying the Rule in its current form, but also a careful review and re-thinking of portions of both Rule G-23 and Rule G-42, especially areas relating to municipal advisor responsibilities to public entity clients and conflict of interest and risk disclosures. In particular, I urge that the Board use this opportunity to re-consider the disclosures required regarding conflicts of interest, both to strengthen the disclosure process and also to take into account a wide variety of serious conflicts of interest that may not have been identified sufficiently explicitly at the time of the proposal and adoption of either Rule G-23 or Rule G-42, but that have subsequently come to light in real life circumstances.

I believe that I have had unique interactions with Rule G-23 and actions of underwriters and financial advisors (today, known as municipal advisors) throughout my more than 40 years of active participation in the municipal securities market. In that connection, I believe that I have distinctive perspectives that few others have. In certain respects, I may be able to provide useful information that few others can provide.

It is relevant that I served as General Counsel of the Government Finance Officers Association (GFOA) in the 1970s when Rule G-23 was first proposed and adopted, that I served as an underwriter with three regional dealer firms in the 1980s and 1990s, giving me the opportunity to view the actions of underwriters in relation to Rule G-23, and that, from the 1990s

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into the 2010s, I served as a financial advisor (municipal advisor) in my own firm, American Governmental Financial Services Company, and also in 2012 and 2013 as General Counsel of Government Financial Strategies, Inc. prior to my cessation of financial/municipal advisory activities in 2013. Since 2013, I have served solely as a litigation consultant in municipal bond related cases, a number of them involving financial/municipal advisors. Before 2013, I also served as a litigation consultant, but as noted, not exclusively. I also have served as a bond, issuer, disclosure, investor, underwriter and trustee counsel.

I describe below my varied experiences and perspectives arising from what I consider to be an unusual combination of activities as an issuer representative, underwriter and financial/municipal advisor.

Given circumstances, I am taking this opportunity to communicate with the MSRB and its staff, and hopefully indirectly the Commission and the market, on certain matters of considerable interest to me. Therefore, I am presenting as much relevant information and analysis as I deem potentially useful regarding Rule G-23 and Rule G-42. I also present background and other information I consider relevant to the discussion, with a view to the foundations underlying municipal advisors' fiduciary relationships with their clients.

### **Rule G-42 Does Not "Create" Municipal Advisors' Fiduciary Duty**

Because I have encountered in my litigation consulting activities significant confusion among municipal advisors in this regard, I note that the federal fiduciary duty of municipal advisors to their public entity clients is a statutory duty. In that connection, Section 15B(c)(1) of the Securities Exchange Act, as amended in 2010 by the Dodd-Frank Act provides:

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.

In addition, Section 15B(a)(5) of the 1934 Act contains a special antifraud provision directed at municipal advisors, as follows:

No municipal advisor shall make use of the mails or any means or instrumentality of interstate commerce to provide advice to or on behalf of a municipal entity ... with respect to ... the issuance of municipal securities ... in connection with which such municipal advisor engages in any fraudulent, deceptive, or manipulative act or practice.

Several courts have held that municipal advisors have fiduciary duties to their clients under state law. I am not aware of any judicial decision holding that financial/municipal advisors generally do not have fiduciary duties to their clients. Further, long prior to the enactment of the Dodd-Frank Act, the Commission engaged in significant enforcement activity, in the process recognizing state law fiduciary principles.

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Municipal advisors also are subject, of course, to MSRB Rule G-17's broad fair dealing mandate and antifraud prohibition that may lead to liability in connection with dealings with non-clients.

The federal fiduciary duty, which as noted is a statutory duty, did not arise from MSRB Rule G-42, but is largely, although not totally, explained in the Rule. Some municipal advisors do not understand this important distinction.

MSRB Rule G-42, which became effective on June 23, 2016, provides guidance and assistance to municipal advisors on how to satisfy the statutory fiduciary duty, which pre-existed Rule G-42. To be precise, MSRB Rule G-42 does not "create" or "impose" the federal fiduciary duty, including the duty of care and the duty of loyalty, but rather, as described in the statute, "prescribe[s] means reasonably designed to prevent" municipal advisors from committing acts inconsistent with the federal fiduciary duty (which as noted was already in effect when Rule G-42 was adopted), and to provide assistance and guidance to municipal advisors in that respect.

In that connection, Securities Exchange Act §15B(b)(2) provides:

*The Board shall propose and adopt rules to effect the purposes of this title with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers and advice provided to or on behalf of municipal entities or obligated persons by brokers, dealers, municipal securities dealers, and municipal advisors with respect to municipal financial products, the issuance of municipal securities, and solicitations of municipal entities or obligated persons undertaken by brokers, dealers, municipal securities dealers, and municipal advisors. The rules of the Board, as a minimum, shall:*

\* \* \*

(L) with respect to municipal advisors—

- (i) *prescribe means reasonably designed to prevent acts, practices, and courses of business as are not consistent with a municipal advisor's fiduciary duty to its clients ... [Emphasis added.]*

Shortly following the Dodd-Frank Act's effectiveness with respect to municipal advisors, including the fiduciary duty, the Board described its rulemaking role regarding the fiduciary duty as follows:<sup>1</sup>

The Dodd-Frank Act provides that MSRB rules for municipal advisors must, among other things: ... prescribe means *reasonably designed to prevent acts, practices, and*

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<sup>1</sup> MSRB Notice 2010-47, *Application of MSRB Rules to Municipal Advisors* (Nov. 1, 2010). See also MSRB Notice 2012-25, *Securities and Exchange Commission Approves Interpretive Notice on the Duties of Underwriters to State and Local Government Issuers* (May 7, 2012) ("act in the best interests of the issuer without regard to its own financial or other interests").

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*courses of business that are not consistent with a municipal advisor's fiduciary duty to its municipal entity clients . . . . [Emphasis added.]*

The Board stated further that it:

*expects to provide guidance on the definition of "municipal advisor" and what it means for a municipal advisor to have a fiduciary duty to a municipal entity, as provided for in the Dodd-Frank Act. [Emphasis added.]*

In a footnote, the Board added:

*Municipal advisors should note that, pursuant to Section 15B(c)(1) of the Exchange Act, they are subject to a federal fiduciary duty to their municipal entity clients as of October 1, 2010, even before MSRB rulemaking on the subject. [Emphasis added.]*

Thus, Rule G-42 did not create the federal fiduciary duty, or define the duty in its totality. Rather, the fiduciary duty is contained in the statute (and state law). Rule G-42 provides certain guidance regarding compliance with the federal statutory duty.

In proposing Rule G-42, the Board recognized that its role is to provide guidance and assistance to municipal advisors in satisfying their statutory obligations. For example, the Board stated:<sup>2</sup>

*[T]he Dodd-Frank Act itself specifically establishes that a fiduciary duty is owed by a municipal advisor to its municipal entity clients.*

\* \* \*

*Draft Rule G-42 elaborates on the duties of a municipal advisor, including the fiduciary duties of a municipal advisor towards its municipal entity clients.*

\* \* \*

The Supplementary Material in the draft rule *provides guidance* on the meaning of the duty of care and the duty of loyalty.

\* \* \*

*The Dodd-Frank Act establishes a federal regulatory regime that requires municipal advisors to register with the SEC, grants the MSRB certain regulatory authority over municipal advisors, and imposes, among other things, a federal statutory fiduciary duty on municipal advisors when advising municipal entity clients. Municipal advisors advising municipal entities are prohibited from engaging in any act, practice, or course of business which is not consistent with that fiduciary duty. In addition, Congress directed that the MSRB develop rules reasonably designed to*

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<sup>2</sup> MSRB Notice 2014-01, *Request for Comment on Draft MSRB Rule G-42, on Duties of Non-Solicitor Municipal Advisors* at 3, 5, 7, 17-18, 22 (Jan. 9, 2014). [Emphasis added.] See also MSRB Notice 2014-12, *Request for Comment on Revised Draft MSRB Rule G-42, on Duties of Non-Solicitor Municipal Advisors* (July 23, 2014).

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*prevent acts, practices, or courses of business by municipal advisors that are inconsistent with their fiduciary duty, as applicable. Neither the Dodd-Frank Act nor the recently adopted SEC Final Rule prescribe the duties and obligations of municipal advisors beyond a general statement that municipal advisors shall be deemed to have a fiduciary duty to any municipal entity for whom the municipal advisor acts as a municipal advisor. Therefore, there is a need for regulatory guidance with respect to the duties of municipal advisors and the prevention of breaches of a municipal advisor's fiduciary duty to its municipal entity clients. ...*

The MSRB believes that by articulating specific standards of conduct and duties for municipal advisors, *draft Rule G-42 will assist municipal advisors in complying with the statutorily-imposed requirements* of the Dodd-Frank Act, and help prevent failures to meet those requirements. The draft rule is expected to aid municipal entities and obligated persons that choose to engage municipal advisors in connection with their issuances of municipal securities as well as transactions in municipal financial products by promoting higher ethical and professional standards of such advisors. The MSRB also believes that articulating standards of conduct and duties of municipal advisors will enhance the ability of the MSRB and other regulators to oversee the conduct of municipal advisors, as contemplated by the Dodd-Frank Act. [Emphasis added.]

\* \* \*

Although *the statute imposed this fiduciary duty*, it does not describe or clarify its elements. *Draft Rule G-42 can be viewed as establishing guidance and clarification with respect to this fiduciary duty and potentially prescribing means designed to prevent breaches of this duty.*

\* \* \*

The MSRB believes that the *draft rule provides needed guidance and clarification with respect to the standards of conduct and duties of a municipal advisor that would meet the purposes of the Dodd-Frank Act.* The draft rule also prescribes for municipal advisors *means that may prevent breaches of these duties.* Therefore, this *guidance* provides a benefit to municipal advisors who could otherwise face greater uncertainty about the standards of conduct and duties required to meet certain of the requirements of the Dodd-Frank Act, particularly, as noted, given the regulatory framework for municipal securities regulation involving multiple enforcement organizations.

In other words, Rule G-42 is a means to an end—guiding and assisting municipal advisors in complying with their statutory fiduciary duty, which is expressed in principles-based terms and exists independently of Rule G-42. Rule G-42 is not, in and of itself, the end product in the definition of the extent and content of municipal advisors' fiduciary duties.

In considering how the principles of Rule G-23 may interact with Rule G-42, it may be useful to consider some general principles applicable to the relationships between municipal advisors and their clients. One set of principles is contained in the state common law of agency. There are further principles of fiduciary duty that follow my brief summary of certain agency principles.

**Municipal Advisors as Agents**

Although it is rarely discussed in the municipal securities market in explicit terms, and so far as I can determine, not at all by the Board, it is important, in describing the fiduciary duty of municipal advisors, to recognize that municipal advisors are virtually always agents of their clients, both municipal entity clients and obligated person clients.<sup>3</sup>

Agents are fiduciaries under common law. The common law fiduciary duty principles applicable to municipal advisors are strict and demanding. I urge the Board to consider carefully whether Rule G-23 and Rule G-42 recognize those principles appropriately in all material respects for purposes of the federal statutory duty, especially with respect to municipal advisor disclosure of, and client consents to, conflicts of interest and associated risks.

The **RESTATEMENT OF AGENCY THIRD** §1.01 defines “agent,” as follows:

**§1.01 Agency Defined**

*Agency is the fiduciary relationship that arises when one person (a “principal”) manifests assent to another person (an “agent”) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act. [Emphasis added.]*<sup>4</sup>

While, in a purely theoretical sense, municipal advisors possibly may avoid agency status by not dealing with third persons on behalf of the advisors’ clients, in reality, this is an almost

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<sup>3</sup> As a side note, I make the same observation regarding agency roles of bond counsel and disclosure counsel, as well as local counsel, to municipal entities.

<sup>4</sup> See also *In the Matter of Daisy Systems, Inc.*, 97 F. 3<sup>rd</sup> 1171 (9<sup>th</sup> Cir. 1996), in which the Court of Appeals for the Ninth Circuit opined under California law that confidentiality is an element of a fiduciary relationship and held that a financial advisor to a sophisticated corporation would have a fiduciary duty if the trial court found that the advisor had functioned as an agent (“Should a factfinder determine from the record that an agency relationship existed between the parties, ... then a fiduciary relation should be presumed to exist.”)

The Court stated:

Two important issues of fact that must be resolved before it can be determined whether a fiduciary relationship existed between Daisy and Bear Stearns are the *questions of agency and confidentiality*. As *confidentiality is an element of a fiduciary relationship ...* resolution of the fiduciary question in this case will turn in part on whether Daisy reposed confidences in Bear Stearns. *Moreover*, among the terms of Bear Stearns’ retention was a provision stating that *it would be acting on Daisy’s behalf*. *Should a factfinder determine from the record that an agency relationship existed between the parties, ..., then a fiduciary relation should be presumed to exist.* [Emphasis added.]

See further *SEC v. Cochran, et al.*, 214 F.3d 1261 (10<sup>th</sup> Cir. 2000) (“When one party expressly or implicitly agrees to act as an agent or broker on behalf of another party, *Oklahoma law imposes on the agent a fiduciary duty to disclose to the principal all material facts within the scope of the agency.*”) [Emphasis added.]

impossible occurrence. Further, municipal advisors provide advice on behalf of, and purportedly in the best interests of, their clients.<sup>5</sup>

Municipal advisors routinely consent contractually to represent and advise their municipal securities issuer clients both during the offering process and on a continuing basis, to act on behalf of and subject to the control of the advisors' issuer clients, and to communicate on the issuer clients' behalves with many third parties such as, among others, bond counsel, local issuer counsel, auditors, bond trustees, rating agencies, private obligors in conduit bond issues, bond banks, information providers (*e.g.*, in gathering economic, demographic and other statistical data for official statements), and investors making inquiry.

Municipal advisors also have relationships with municipal entities to provide specialized expert financial advisory services to, and solely in the best interests of, the municipal entities without regard to the advisors' own financial or other interests. There is a common imbalance of knowledge and expertise between the advisors and their clients. In part as a result of municipal advisors' inducement to municipal entities to rely upon the advisors, typically the clients place a high degree of trust and confidence in the advisors.

The clients control the actions of municipal advisors by retaining the ultimate approval of recommendations made by the advisors and by the ability to terminate the contracts between them in the event of unsatisfactory service.

### **Municipal Advisors Must Warn Against Risk—Silence Is Not an Option for Fiduciaries**

Municipal advisors acting, among other things, as agents are recognized by municipal market practitioners as fiduciaries, as well as by market and legal authority. This means that municipal advisors have a duty to provide information affirmatively to their clients<sup>6</sup> Although for

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<sup>5</sup> I note that, insofar as state law is relevant, these facts and circumstances apply in municipal advisors' relationships with obligated person clients, as well as municipal entity clients.

<sup>6</sup> As discussed below, the **RESTATEMENT OF AGENCY THIRD** makes clear that agents are fiduciaries, have a duty to act solely in their principals' best interests, and have an affirmative duty to provide information to the principals, even if the agents believe that the principals know or are able to discover the information on their own.

The general rule relating to business dealings conducted by principals dealing at arms'-length, such as underwriters, and by other non-fiduciary professionals, is set forth in the **RESTATEMENT OF TORTS SECOND**, §551(1), as follows:

- (1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question. [Emphasis added.]



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The **RESTATEMENT'S** § 551(2), however, distinguishes fiduciary relationships from normal business dealings in that fiduciaries, unlike typical business persons, including non-fiduciary professionals, have an affirmative duty to speak, as follows:

(2) *One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,*

(a) *matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them[.] [Emphasis added.]*

Robert Fippinger agrees in his authoritative two-volume treatise, **THE FEDERAL SECURITIES LAW OF PUBLIC FINANCE**, Ch. 14, Fraud Concepts in Public Finance, §§14:11 at 14-163, 14:11.5 at 14-182, 14:11.7 at 14-194 (Practising Law Institute), as follows:

In a case of nondisclosure, Anglo-American law tilts in favor of the person choosing to remain silent *requiring an affirmative duty to speak only in limited circumstances in which the defendant has a special relationship to the person injured or situations in which the nondisclosure substantially mimics a misrepresentation. Among these special relationships is that of a fiduciary having duties of loyalty and care to a beneficiary.*

\* \* \*

To prevent a breach of fiduciary duty from also being fraudulent conduct *it is necessary for the fiduciary to disclose information material to a beneficiary's decision to act or refrain from acting* in a business transaction prior to the time the beneficiary acts or refrains from acting.

\* \* \*

*Fiduciary fraud is an exception to the general rule that a person is ordinarily entitled to remain silent despite possessing information that would be material to another. If a person is in a "fiduciary or other similar relation of trust and confidence" there is a duty to disclose the material facts, and failure to make the disclosure is fraud.* [Footnote omitted; emphasis added.]

The **RESTATEMENT OF AGENCY THIRD** §8.01 states a general fiduciary principle applicable to agents:

**§ 8.01 General Fiduciary Principle**

*An agent has a fiduciary duty to act loyally for the principal's benefit* in all matters connected with the agency relationship. [Emphasis added.]

The **RESTATEMENT'S** Comment to §8.01 states in part that an agent must "subordinate the agent's interests to those of the principal and place the principal's interests first," citing as a "breach of the agent's duties of loyalty to the principal" "an agent's failure to provide material information to the principal," as follows:

the general fiduciary principle requires that the agent subordinate the agent's interests to those of the principal and place the principal's interests first as to matters connected with the agency relationship.

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\* \* \*

*An agent's failure to provide material information to the principal may facilitate the agent's breach of the agent's duties of loyalty to the principal.*

\* \* \*

Unless the principal consents, the general fiduciary principle ... also requires that an agent refrain from using the agent's position ... to benefit the agent ... . [Emphasis added.]

The **RESTATEMENT** §8.06 speaks to how agents are able to obtain effective consents from their principals regarding conflicts of interest through full material disclosure of specific information and informed client consents, as follows:

**§8.06 Principal's Consent**

(1) Conduct by an agent that would otherwise constitute a breach of duty as stated in §§ 8.01 ... does not constitute a breach of duty if the principal consents to the conduct, *provided that*

(a) *in obtaining the principal's consent, the agent*

(i) *acts in good faith,*

(ii) *discloses all material facts that the agent knows, has reason to know, or should know* would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and

(iii) *otherwise deals fairly* with the principal; and

(b) *the principal's consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship.* [Emphasis added.]

The **RESTATEMENT'S** Comment to §8.06 describes client consents, as follows:

The validity of the principal's consent turns in many respects on the agent's conduct in obtaining it.

\* \* \*

[W]hen a principal consents to specific transactions or to specified types of conduct by the agent, the principal has a focused opportunity to assess risks that are more readily identifiable.

\* \* \*

A principal may consent to an agent's receipt of a material benefit in connection with ... actions taken on behalf of the principal or otherwise through the agent's use of position.

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The **RESTATEMENT** §8.08 discusses the agent’s duties of “care, competence and diligence,” especially “[i]f an agent claims to possess special skills of knowledge,” as municipal advisors commonly claim on their websites and in other advisor communications to clients, as follows:

**§ 8.08 Duties of Care, Competence, and Diligence**

Subject to any agreement with the principal, *an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances. Special skills or knowledge possessed by an agent are circumstances to be taken into account in determining whether the agent acted with due care and diligence. If an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge.* [Emphasis added.]

The **RESTATEMENT** §8.11 discusses further the agent’s affirmative duty to provide information to the principal:

**§8.11 Duty to Provide Information**

An agent has a *duty to use reasonable effort to provide the principal with facts* that the agent knows, has reason to know, or should know when

- (1) subject to any manifestation by the principal, *the agent knows or has reason to know that the principal would wish to have the facts or the facts are material to the agent’s duties to the principal*[.] [Emphasis added.]

The **RESTATEMENT’S** Comment to §8.11 states that the agent’s duty to provide information to the principal requires the agent to do so even if the agent believes “that the principal could, through investigation, have ascertained the truth independently,” noting that an agent’s potential benefit “if a principal completes a transaction may tempt the agent not to furnish information,” adding “such disclosure, to be effective, must be made to a disinterested decisionmaker who has authority within the organization,” as follows:

A principal has a right to rely on advice given by an agent and on the agent’s accurate transmission of material information to the principal. *It is not a defense to an agent’s breach of duty to transmit material information that the principal could, through investigation, have ascertained the truth independently.*

*... [I]t is possible that the benefit that an agent anticipates receiving if a principal completes a transaction may tempt the agent not to furnish information to the principal when the agent believes that the principal might on that basis reconsider the transaction or its terms, with results unfavorable for the agent.*

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In an organizational setting, such *disclosure, to be effective, must be made to a disinterested decisionmaker* who has authority within the organization to determine whether the agent’s conduct is consistent with the organization's interests. [Emphasis added.]

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purposes of the Dodd-Frank Act, the statutory federal fiduciary duty is imposed only upon municipal advisors to municipal entities, for state law purposes, as discussed in this letter, the common law fiduciary duty is not so limited.<sup>7</sup>

One of the core roles and responsibilities of municipal advisors is to inform their issuer clients about risks relevant to the advisors' scope of services (as well as other risks of which the advisors are aware or should be aware) and to educate the clients about how to manage, mitigate and avoid such risks. Such risks were present in activities accommodated by Rule G-23 in its prior form, and could re-emerge if advisors are permitted again to serve as underwriters.<sup>8</sup>

Prior to the enactment of the federal fiduciary duty in the Dodd-Frank Act, municipal issuers were subject to repeated abuses and incompetence by their bond financial advisors, who have been from the date of effectiveness of the Dodd-Frank Act the core municipal advisors.<sup>9</sup> In particular, advisors failed to warn and inform their issuer clients adequately regarding transactional risks of complex financial transactions. Warning clients about transactional risks is one of the central motivating purposes supporting enactment of the Dodd-Frank Act's municipal advisor provisions.

The municipal advisory relationship is one of a highly specialized expert character. Municipal advisors should possess the ability to recognize risks that clients may not recognize or at least may not appreciate fully. Among other things, municipal advisory clients expect their municipal advisors to perform professional investigations in support of recommendations the advisors make to the municipal entity clients and to communicate affirmatively in order fully to inform the issuers of information that the municipal advisors know, or should know is important to the issuers. It does not matter that the advisors may think the clients could discover the

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<sup>7</sup> When and if municipal entities or obligated persons bring civil actions against municipal advisors, those actions almost invariably will involve state law claims.

<sup>8</sup> Even now, as discussed below, despite warnings by the Board and the Commission, some municipal advisors, including advisors who are not registered as broker-dealers, receive contingent compensation while identifying and soliciting potential investors and negotiating bond terms, thus serving as placement agents for their clients.

<sup>9</sup> See, e.g., Van Natta, "*Firm Acted a Tutor as It Sold Risky Deals to Towns*" (New York Times Apr. 8, 2009) (citing many small Tennessee communities that had lost money from complex derivatives transactions); Selway, "*Pennsylvania Should Ban Municipal Derivatives Deals (Update1)*" (Bloomberg.com Nov. 18, 2009) (the Auditor General "made the call after an audit of the Bethlehem Area School District found that officials lost at least \$10.2 million by entering into interest-rate swaps tied to variable-rate bonds, based on an analysis of just two of the district's 13 deals. Since the Legislature explicitly legalized such trades in 2003, school districts, towns and other localities in the state have entered into derivative deals on \$15 billion of debts.")

information on their own—the advisors must take affirmative action to provide the information themselves as the clients’ fiduciaries.<sup>10</sup>

Although there are certain superficial similarities, the negligence standard of the fiduciary duty of care to disclose risks is much more extensive than mere professional negligence prevention for non-fiduciary professionals. This is still a negligence standard for municipal advisors, but in the context of the fiduciary duty, the standard is stronger than it would be for non-fiduciary professionals.

Indeed, although prior to the enactment of the Dodd-Frank Act bond financial advisors and other municipal advisors were subject, as were other professionals, to the potential for claims for professional negligence, the federal fiduciary duty created by the Dodd-Frank Act has transformed the municipal securities market by providing a uniform national standard that is enforceable by the SEC.

Municipal bond issuers rely heavily upon their municipal advisors, and municipal advisors readily accept their fiduciary duties as a key component of their relationships with their municipal entity clients.<sup>11</sup>

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<sup>10</sup> See the discussion above of the fiduciary duty to provide information to the beneficiaries of fiduciary relationships, including among other things, the **RESTATEMENT OF AGENCY THIRD**, §8.11, and the Comment thereto, which states:

It is not a defense to an agent’s breach of duty to transmit material information that the principal could, through investigation, have ascertained the truth independently.

Tamar Frankel states in **LEGAL DUTIES OF FIDUCIARIES: DEFINITIONS, DUTIES AND REMEDIES** at 149-50 (Fathom Publishing Co. 2012) that “The entrustor does not have to ask; the fiduciary must inform and report,” as follows:

*The duty of the fiduciary to disclose information about the ... exercise of entrusted power is not limited to those situations in which the fiduciary was engaged in conflict of interest transactions or violated other rules. It is a duty to tell the entrustor how the fiduciary is providing the services and what happened to the entrustment, regardless of whether the entrustor asked for the information. The entrustor does not have to ask; the fiduciary must inform and report. [Emphasis added.]*

The **RESTATEMENT OF TORTS SECOND** §551, cited in n. 6 above, states the principle that a party in a fiduciary relationship cannot remain silent, but is obligated affirmatively to provide important information to the beneficiary of the relationship.

As quoted above, in **THE SECURITIES LAW OF PUBLIC FINANCE**, Robert Fippinger described the effect of then **RESTATEMENT’S** analysis, as follows:

If a person is in a “fiduciary or other similar relation of trust and confidence” there is a duty to disclose the material facts, and failure to make the disclosure is fraud.

<sup>11</sup> See GFOA, **RECOMMENDED PRACTICE—SELECTING FINANCIAL ADVISORS** (2008); GFOA’s **BEST PRACTICE—SELECTING AND MANAGING MUNICIPAL ADVISORS** (Feb. 2014) (“A municipal advisor represents the issuer in the sale of bonds, and unlike other professionals involved in a bond sale, has an

Because so many municipal issuers do not have bond structuring capabilities, and bond issuance is one of their greatest financial obligations, if not the greatest, the fiduciary duty of care of bond financial advisors and other municipal advisors is an essential protection for municipal bond issuers who rely on the advisors to disclose risks and benefits associated with bond structure alternatives.<sup>12</sup>

Key distinctions of the fiduciary duty of care establishing the negligence standard for municipal advisors from mere professional negligence for non-fiduciary professionals include the following:

- Unlike non-fiduciary professionals, the municipal advisor has an affirmative duty to speak, not only to avoid misleading statements. The municipal advisor, as a fiduciary, does not have the option to remain silent on important relevant matters, and unlike non-fiduciary professionals, cannot omit to inform the issuer client of important relevant information.<sup>13</sup>

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explicit fiduciary duty to the issuer per the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). ... The Government Finance Officers Association (GFOA) recommends that issuers hire a municipal advisor prior to the undertaking of a debt financing unless the issuer has sufficient in-house expertise and access to current bond market information.”); **RECOMMENDED PRACTICE—SELECTING UNDERWRITERS FOR NEGOTIATED BOND SALES (2008)**; **BEST PRACTICE—SELECTING AND MANAGING UNDERWRITERS FOR NEGOTIATED BOND SALES (2014)** (“Issuers must keep in mind that the roles of the underwriter and the municipal advisor are separate, adversarial roles and cannot be provided by the same party. There is no federal law establishing an underwriter’s fiduciary responsibility to the issuer.”), and **RECOMMENDED PRACTICE—SELECTING UNDERWRITERS FOR NEGOTIATED BOND SALES (2008)** (“A financial advisor represents only the issuer and has a fiduciary responsibility to the issuer.”)

See also the **CODE OF PROFESSIONAL CONDUCT AND ETHICS** of the National Association of Municipal Advisors, stating, among other things, that:

NAMA members are expected to understand and conduct themselves in a manner that meets and exceeds federal regulatory standards, state or local laws, or other applicable duties that apply to Municipal Advisors. This includes abiding by the federal fiduciary duty, where the interests of the client must come first and be above the interests of the individual MA or the MA Firm. In addition to federal regulations, Municipal Advisors must follow all state and local laws and codes that apply in the jurisdiction where they practice. In the event of a conflict in law or regulation, NAMA members must comply with the more strict law or regulation.

<sup>12</sup> It is also an important protection for municipal bond investors because the issuers are able to issue bonds based upon municipal advisors’ expert bond structure advice.

<sup>13</sup> See the resources cited in nn. 6 and 10 above.

- Unlike non-fiduciary professionals, the municipal advisor must act and communicate solely in the best interests of the municipal issuer without regard to the financial or other interests of the municipal advisor.<sup>14</sup>
- Unlike non-fiduciary professionals, the municipal advisor must provide important information to the client, even if the client does not ask for the information and even when the advisor believes that the client could discover the information on its own.<sup>15</sup>
- In addition to the fiduciary duty of care, unlike non-fiduciary professionals, municipal advisors are subject to the duty of loyalty requiring them to avoid conflicts of interest as to which the municipal issuer client has not consented on a

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<sup>14</sup> In 2012, the MSRB described distinctions between the underwriters' and municipal advisors' roles, as follows:

unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, *not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests ...*

[MSRB Notice 2012-25, *Securities and Exchange Commission Approves Interpretive Notice on the Duties of Underwriters to State and Local Government Issuers* (May 7, 2012).] [Emphasis added.]

<sup>15</sup> See the resources cited in nn. 6 and 10 above.

fully-informed basis.<sup>16</sup> Significantly, the burden is on the municipal advisor to prove disclosure of, and client consents to, conflicts of interest.<sup>17</sup>

Thus, the fiduciary duty pervades the relationship and all activities and communications of municipal advisors with their issuer clients.

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<sup>16</sup> Tamar Frankel identifies in **FIDUCIARY LAW** at 106-07 (Oxford University Press 2011) the duties of fiduciaries to their beneficiaries (which she calls “entrustors”), as follows:

- The *duty of loyalty*, relating to entrusted ... power.
- The *duty of care*, relating to the *quality and care of fiduciaries’ performance* of their services.

Based on the duty of loyalty are a number of additional duties:

- The *duty to follow and abide by the directives of entrustment* with respect to the entrusted power ... .
- The *duty to act in good faith* in performing fiduciary services.

\* \* \*

- The *duty to ... disclose relevant information* to the entrustors.
- The *duty to treat entrustors fairly*. [Footnotes omitted; emphasis added.]

The **RESTATEMENT OF AGENCY THIRD** §8.01 states a general fiduciary principle applicable to agents:

**§ 8.01 General Fiduciary Principle**

*An agent has a fiduciary duty to act loyally for the principal’s benefit* in all matters connected with the agency relationship. [Emphasis added.]

<sup>17</sup> The **RESTATEMENT OF AGENCY THIRD’S** Comment to §8.06 states that “An agent has the burden of establishing that the principal consented,” as follows:

*An agent has the burden of establishing that the principal consented* to the agent’s acquisition of a material benefit. *The rule entitles the principal to assume that the agent will make the disclosures requisite to effective consent by the principal.* [Emphasis added.]

This fundamental principle should be embedded in Rule G-23 and Rule G-42.

In other words, municipal advisors must make disclosure of conflicts of interest in a readily-understandable manner. Moreover, the municipal entity’s official receiving the disclosure must not be conflicted and must be an official with real authority, not an underling or just another agent.



Rule G-23 and Rule G-42 should require, through explicit provisions, that municipal advisors make clear, understandable disclosure to client officials with full authority to provide effective consents.<sup>18</sup>

As noted above, the federal fiduciary duty was enacted due to many serious abuses committed by municipal advisors who had expected mere professional negligence, as measured by non-fiduciary standards, and the difficulties of litigation for municipal entities to protect the advisors from liability for nondisclosure prior to the financial crisis of 2007 to 2009. Large numbers of municipal entities suffered significantly adverse financial consequences from having entered into complex transactions on the basis of incompetent, and often conflicted, advice and with excessive, and often undisclosed, risks. Municipal entities' financial advisors failed to alert the entities affirmatively regarding the significant risks, while advising the entities in positive terms about transactions with inadequate care and investigation.<sup>19</sup>

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<sup>18</sup> Importantly, it bears repeating that the **RESTATEMENT OF AGENCY THIRD'S** Comment to §8.11 states that:

In an organizational setting, such *disclosure, to be effective, must be made to a disinterested decisionmaker who has authority within the organization to determine whether the agent's conduct is consistent with the organization's interests.* [Emphasis added.]

In other words, the municipal entity's official(s) receiving the disclosure must not be conflicted and must possess real decision-making authority, as opposed to junior officials or other agents.

<sup>19</sup> Municipal entities now have much greater protection under the national uniformity provided by federal law both through the federal fiduciary duty of due care and the duty of loyalty, which may be enforceable not only by the issuers, but also by the SEC.

As stated by Robert Fippinger in his treatise, **THE FEDERAL SECURITIES LAW OF PUBLIC FINANCE**:

[T]he substantive obligations of a section 15B(c)(1) municipal advisor fiduciary are to be articulated as a matter of federal law. This conclusion is important because it means that a single standard can be established without the necessity of relying on the fiduciary duty law of fifty different states in which various transactions occur.

[R. Fippinger, **THE FEDERAL SECURITIES LAW OF PUBLIC FINANCE**, Ch. 11, Municipal Advisor Regulation at §11:12.1, p. 11-97 (Practising Law Institute, New York, Rel. #6, 9/17); see also §11:1.1, p. 11-9, stating, "The statutory fiduciary duty is a federal standard that applies in addition to any state law impositions of a fiduciary duty ... ."]

An application of the fiduciary duty of due care is illustrated by an enforcement action brought by the Securities and Exchange Commission enforcing the federal fiduciary duty of due care against a municipal advisory firm, Municipal Finance Services, Inc., and two officials of the firm, in SEC Rel. No. 81475, IA-4758 (Aug. 24, 2017), when the firm and its officers failed to advise a municipal securities issuer affirmatively and appropriately in connection with a bond offering in 2013 of the need to disclose information to investors ("Section 15B(c)(1) of the Exchange Act imposes upon municipal advisors and their associated persons a fiduciary duty to their municipal entity clients, and prohibits them from engaging in any act, practice or course of business that is not consistent with their fiduciary

I also note that, as discussed below, the federal fiduciary duty set forth in the Dodd-Frank Act reaches responsible municipal advisor officials, including the individual advisors violating the fiduciary duty and, importantly, controlling persons of a municipal advisory firm, which a professional negligence cause of action often would not reach.

To summarize, municipal entities issuing bonds into the market need the expert services of municipal advisors, including warnings regarding risks. Of the estimated 50,000 municipal bond issuers,<sup>20</sup> the vast majority are small or unsophisticated in terms of municipal finance and bond structuring, or both. In a democracy, the public agencies function with elected or appointed governing bodies and key staff who are everyday people who, even of successful in one or another field, commonly know little or nothing about municipal finance. The public agencies generally also lack access to expensive software and municipal market data and information resources necessary to structure bond issues appropriately.

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duty. *Fiduciaries must act in the utmost good faith and use reasonable care to avoid misleading clients. ... MFSOK willfully breached its fiduciary duty.*) [Emphasis added.]

That enforcement action based on the statutory fiduciary duty of care would not have been possible under federal law prior to the enactment of the fiduciary duty in the Dodd-Frank Act.

Additional post-Dodd-Frank Act SEC actions enforcing the duty of loyalty against municipal advisors (most of which relate to bond issues prior to the adoption of Rule G-42) include: *Barcelona Strategies LLC, et al.*, SEC Rel. Nos. 34-83191, IA 33093 (May 9 2018) (failure to disclose relationship with bond counsel in bond issues in 2013, misleading advertising); *In the Matter of Central States Capital Markets LLC, et al.*, SEC Rel. Nos. 34-77369, IA-4352, IC-32027 (March 15, 2016) (arising from activities in 2011, including an undisclosed relationship with an underwriter); *In the Matter of School Business Consulting, Inc., et al.*, SEC Rel. Nos. 34-78054, IC-32147 (June 13, 2016) (arising from activities initiated in 2010, including an undisclosed relationship between a municipal advisor and a school consultant); and *In the Matter of Keygent LLC, et al.*, SEC Rel. No. 34-78053 (June 13, 2016) (arising from activities initiated in 2010, including an undisclosed relationship between a municipal advisor and a school consultant); *In the Matter of Malachi Financial Products, Inc., et al.*, SEC Rel. Nos. 34-83607 (July 9, 2018) and *In the Matter of Porter Bingham*, SEC Rel. No. 34-83608 (July 9, 2018) (municipal advisor and its principal failed to disclose to the advisor's issuer client that the advisor had received payments in May 2015 from an underwriter the advisor recommended to the client and the advisor submitted in 2015 fraudulent invoices for services the advisor had not performed); and *In the Matter of Dale Scott & Co., et al.*, SEC Rel. No. 34-86393 (July 16, 2019); *In the Matter of Oetken*, SEC Rel. No. 34-86395 (July 16, 2019); and *In the Matter of School Services of California*, SEC Rel. No. 34-86396 (July 16, 2019) (undisclosed relationships between a municipal advisor and school consultants serving as unregistered solicitors).

<sup>20</sup> Schapiro, "Speech by SEC Chairman: Address before the New York Financial Writers' Association Annual Awards Dinner" (June 18, 2009) ("nearly 50,000 state and local issuers").

See also SEC Rel. No. 34-62184A at 7-8 (May 26, 2010), 75 F.R. 33100 at 33101 (June 10, 2010) ("there are approximately 51,000 state and local issuers of municipal securities, ranging from villages, towns, townships, cities, counties, and states, as well as special districts, such as school districts and water and sewer authorities.")

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As stated in GFOA's **BEST PRACTICE—SELECTING AND MANAGING MUNICIPAL ADVISORS** (Feb. 2014):

*State and local governments engage municipal advisors to assist in the structuring and issuance of bonds ... .*

*A municipal advisor represents the issuer in the sale of bonds, and unlike other professionals involved in a bond sale, has an explicit fiduciary duty to the issuer per the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).*

\* \* \*

*The Government Finance Officers Association (GFOA) recommends that issuers hire a municipal advisor prior to the undertaking of a debt financing unless the issuer has sufficient in-house expertise and access to current bond market information.*

\* \* \*

*The GFOA recommends that issuers select municipal advisors on the basis of merit using a competitive process and that issuers review those relationships periodically. [Emphasis added.]*

### **Contingent Compensation**

It is important to keep in mind that more than a few bond issues are conducted and closed without advice from *any* transaction participant—financial or legal—who does not receive contingent compensation. In those transactions, no participant is able to speak up to urge the issuer to exercise care regarding the presence of risks without incurring the potential delay in receipt of compensation or even the termination of the transaction and complete or substantial loss of compensation.

If municipal advisors are permitted to underwrite the bonds issued by their clients, one question is whether the advisor/underwriter will be permitted to retain two forms of compensation, regardless of whether contingent or noncontingent. Another question is how contingencies may be tolerated, especially if an advisor now may be motivated by two contingent fees in order to close the bond issue.

A further question arises in the context of municipal advisors who receive compensation contingent on transactional completion while identifying investors in negotiated bond offerings, selling bonds through negotiation (as opposed to competitive bid procedures typical for municipal advisors), and negotiating bond terms directly with securities investors. The contingent compensation radically increases the pressures on municipal advisors to complete transactions, as opposed to providing optimal advice solely in the best interests of the advisors' clients as to whether a transaction is wise, is the best alternative, needs modification that may introduce delay, or should be investigated further.

Some contingent fees should be prohibited completely, regardless of disclosure. For example, fees based upon transactional size, which are a typical form of underwriting and placement agent compensation, should not be permitted at all.<sup>21</sup>

In addition, if fees are linked to bond issue closings, municipal advisors and lawyers may work for many months on bond transactions without the prospect of receiving compensation unless bond issues close. That is a tremendous conflict of interest. The individuals working on the transactions are human beings who must make a living. If they do not close the transactions in which they receive contingent fees, they may be unable to continue long in business. In addition, they are subject internally to often intense pressure from firm members and partners to close the transactions so their firms can be paid. Not only that, but other transaction participants may be highly critical of, and may exert substantial pressure opposing, transactional (and compensation) delays or terminations.

The conflicts are especially pernicious in those transactions that are complex and that present difficult questions associated with issuer risks. That is specifically when unbiased advice is especially required and most significant.

It is crucial in those difficult transactions that someone who does not have a stake in the completion of the transaction speak up to warn the issuer of risks, the potential consequences of the risks, and the need to exercise care. Indeed, the Dodd-Frank Act municipal advisor provisions were enacted in part in response to abuses that occurred prior to the financial crisis in complex financial transactions without warnings to issuers—especially small, inexperienced and infrequent issuers—regarding the risks they were assuming, often completely unknowingly.

Even when issuers may acknowledge generally that there are risks present, they may not fully understand the specific nature or the severity of the risks. The issuers may need an expert financial advisor to provide that information to them.<sup>22</sup>

If such warnings may result in delays and even in uncompleted transactions, it is because that is exactly what is needed for small, unsophisticated, poorly-advised or careless issuers.

The risks of contingent compensation are risks that some issuers may fail to understand adequately.

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<sup>21</sup> Such fees are illegal for financial advisors in California. California Government Code §§53592 (referring to “the basis of compensation for the financial advisory services to be rendered, which ... shall be on a basis other than as a percentage of the amount of the bonds to be sold.”) [Emphasis added.]

<sup>22</sup> See the citations in the preceding notes regarding the obligation of a fiduciary to provide important information to the issuer clients even when an advisor may believe the issuer knows or is able to discover the information on its own.

Although some municipal advisors receive contingent fees, still other municipal advisors decline to do so due to the inherent conflict of interest that may destroy or affect adversely their independence.

It is true that one can describe conflicts associated with virtually any form of compensation. For example, hourly fee structures may create a motivation to pad the time charged on a transaction. That may result in a few hundred, or even thousand, dollars of unearned, or at least excess, compensation.

Those risks and conflicts pale, however, in comparison to the risks and conflicts associated with contingent municipal advisor compensation. Contingent compensation conflicts may lead to the closing of transactions that are unwise. Issuers experiencing defaults or litigation may incur many hundreds of thousands, or millions, of dollars of liability and costs in the form of lawyers' fees and fees of other consultants for re-structurings, workouts or litigation.

It is easy, and misleading to blame issuers alone for this state of affairs. No one may inform the issuers, however, that alternative fee structures are possible. Instead, transaction participants may simply proceed to conduct the transactions on the assumption, without making inquiry about the issuers' informed preferences and without disclosing risks of contingent fees, that contingent fees are what the issuers want. The issuers may have no reason to know that they could have a choice in fee structures or that they should exercise additional care when confronted with contingent advisory fees.

Further, no one may inform issuers that noncontingent fees are payable from bond proceeds. Issuers may believe that fees cannot be covered by bond proceeds. Given the terms of Rule G-42 leaving, in the view of some municipal advisors, disclosure of contingent fee conflicts optional, no one may inform the issuers or their governing bodies of the existence of the conflict of interest inherent in contingent fees. No one may inform the issuers that alternative fee structures may result in lower fees.<sup>23</sup>

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<sup>23</sup> For example, Rule G-42, Supplementary Information .11, Excessive Fees, states:

*Among the factors relevant to whether a municipal advisor's compensation is disproportionate to the nature of the municipal advisory activities performed are ... whether the fee is contingent upon the closing of the municipal securities transaction or municipal financial product ... . [Emphasis added.]*

Indeed, ironically, the MSRB mandates stronger conflict disclosure by underwriters, who are not fiduciaries, regarding contingent compensation than disclosure by municipal advisors who are fiduciaries.<sup>24</sup>

GFOA recognized conflicts of interest of municipal advisors associated with contingent fees payable only when transactions close. For that reason, GFOA stated as early as 2008, prior to the enactment of the Dodd-Frank Act, that “Generally, financial advisory fees should not be paid on a contingent basis,” because the conflicted “advice ... might unnecessarily lead to the issuance of bonds,” as follows:<sup>25</sup>

**Basis of Compensation.** Fees paid to financial advisors *should be on an hourly or retainer basis*, reflecting the nature of the services to the issuer. *Generally, financial advisory fees should not be paid on a contingent basis* to remove the potential incentive for the municipal advisor to provide advice that *might unnecessarily lead to the issuance of bonds*.

[GFOA, **RECOMMENDED PRACTICE—SELECTING FINANCIAL ADVISORS** (2008).]  
[Emphasis added.]

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<sup>24</sup> Rule G-42(b) states the following requirements regarding municipal advisor disclosure regarding contingent compensation, suggesting that municipal advisors may not be automatically required under federal law to disclose conflicts associated with contingent compensation:

A municipal advisor must, prior to or upon engaging in municipal advisory activities, provide to the municipal entity or obligated person client full and fair disclosure in writing of:

(i) all material conflicts of interest, including: ...

(E) *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[.] [Emphasis added.]

In contrast, the Board stated, at least in explicit terms, a more robust description of disclosures required to be made by underwriters, who are not fiduciaries, regarding contingent compensation, as follows:

The underwriter *must disclose* to the issuer *whether its underwriting compensation will be contingent on the closing* of a transaction. It *must also disclose* that compensation that is contingent on the closing of a transaction or the size of a transaction *presents a conflict of interest*, because *it may cause the underwriter to recommend a transaction that it is unnecessary or to recommend that the size of the transaction be larger than is necessary*.

MSRB, *Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities* (Aug. 2, 2012). [Emphasis added.]

Why is this stronger form of disclosure not required of municipal advisors, who are after all fiduciaries? Could it not be required in connection with the review of Rule G-23?

<sup>25</sup> Those views of municipal securities issuers continue in effect today. See GFOA’s **BEST PRACTICE—SELECTING AND MANAGING MUNICIPAL ADVISORS** (Feb. 2014).

Although GFOA also recognized that “this may be difficult given the financial constraints of many issuers,” that statement did not eliminate the conflict of interest and the important responsibility of municipal advisors to disclose the conflict to the issuer clients, to inform the clients of the associated risks, or to obtain the clients’ fully-informed consent to the conflict and associated risks.

I note that issuers, including financially-stressed issuers, routinely pay noncontingent compensation outside the bond offering context to auditors, engineers, lawyers and other professionals.

To emphasize the seriousness of the conflicts of interest for municipal entities, GFOA added in both 2014 and 2008 that:

*In the case of contingent compensation arrangements, issuers should undertake ongoing due diligence to ensure that the financing plan remains appropriate for the issuers needs. [Emphasis added.]*

Recall that the purported need for “ongoing due diligence to ensure that the financing plan remains appropriate” by the issuer occurs when payment of noncontingent compensation “may be difficult given the financial constraints of many issuers.” In other words, precisely the issuers that likely are the ones most in need of unbiased advice are the ones who are cautioned to engage in “ongoing due diligence.” They are precisely the parties who will suffer the most in the event of untoward occurrences.

While there are municipal issuers that may prefer contingent fee structures, there are municipal advisors that never propose any other fee structure to the advisors’ clients and that never give municipal issuers a choice, which some issuers may accept after being informed of the conflicts and associated risks. Indeed, many issuers—regardless of whether they are financially-stressed or financially-sound—have never received any fee proposal from a municipal advisor other than a contingent fee structure.

Moreover, GFOA’s caution regarding financially-stressed issuers undermines directly GFOA’s description in its **BEST PRACTICE** of why municipal issuers should retain municipal advisors, as follows:

*The Government Finance Officers Association (GFOA) recommends that issuers hire a municipal advisor prior to the undertaking of a debt financing unless the issuer has sufficient in-house expertise and access to current bond market information. Issuers should assure themselves that the selected municipal advisor has the necessary expertise to assist the issuer in determining the best type of financing for the government, selecting other finance professionals, planning the bond sale and successfully selling and closing the bonds. [Emphasis added]*

One must ask how an issuer that does not have “sufficient in-house expertise and access to current bond market information” is able to conduct effective “ongoing due diligence to ensure that the financing plan remains appropriate.”

In addition to the fiduciary duty of care, unlike non-fiduciary professionals, municipal advisors, of course, are also subject to the duty of loyalty. Advisors have a duty to avoid significant conflicts of interest as to which the municipal issuer client has not consented on a fully-informed basis. Municipal advisor conflicts of interest deprive municipal entities of key benefits of independent professional advice.

As stated by Tamar Frankel with reference to conflicts of interest, “[F]iduciaries must put entrustors on notice that, in connection with the specified transaction, entrustors cannot rely on their fiduciaries,” as follows:

*When fiduciaries wish to engage in conflict of interest transactions and seek their entrustors’ consent, the entrustors must fend for themselves. Their right to rely on their fiduciaries must be eliminated.*

\* \* \*

*[F]iduciaries must put entrustors on notice that, in connection with the specified transaction, entrustors cannot rely on their fiduciaries.*

\* \* \*

*[F]iduciaries who seek waivers of their fiduciary duties must put entrustors on notice that the entrustors can no longer rely on them in the matter, and that the entrustors must assume full responsibility for defending their own interests.”<sup>26</sup>*  
[Emphasis added.]

The **RESTATEMENT OF AGENCY THIRD**, §8.06, requires that, when a principal consents to an agent’s conflict of interest, certain requirements apply, including the following:

- (a) in obtaining the principal’s consent, the agent (i) acts in good faith, (ii) *discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal’s judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and (iii) otherwise deals fairly with the principal ...* [Emphasis added.]

The Board should consider whether its current Rule G-42 provision relating to disclosure of conflicts arising from municipal advisor contingent compensation effectuates those principles. Recall that the agent has the burden of proving the consent of the principal to a conflict of interest.

Contingent municipal advisor compensation also is a concern for investors who want issuers to receive sound issuance advice in structuring and issuing bonds. The National Federation of Municipal Analysts called in 2001 for disclosure to investors of conflicts of

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<sup>26</sup> Tamar Frankel, **LEGAL DUTIES OF FIDUCIARIES—DEFINITIONS, DUTIES AND REMEDIES** at 158-160 (Fathom Publishing Co. 2012).



interest in NFMA's **RECOMMENDED BEST PRACTICES IN DISCLOSURE FOR GENERAL OBLIGATION AND TAX-SUPPORTED DEBT** at 7 (2001), as follows:

Provide the name of the firm and the individuals along with the city and state of their office for each professional who assisted in the preparation and sale of the securities. This would include parties *such as a financial advisor...* . *If there are any known or suspected conflicts of interest among the professionals and/or the issuer such should be clearly described.* [Emphasis added.]

In 2015, NFMA re-emphasized the importance of disclosure to investors of conflicts of interest specifically arising from municipal advisors' contingent fees in NFMA's **WHITE PAPER ON THE DISCLOSURE OF POTENTIAL CONFLICTS OF INTEREST IN MUNICIPAL FINANCE TRANSACTIONS**, stating, "Contingent compensation is especially undesirable ... for municipal advisors ... who are expected to be independent in the provision of advice or services to issuers or in the structuring of municipal securities," as follows:

Transaction participants may enter into contingent compensation arrangements with payments conditioned on the successful closing or funding of ... municipal finance transactions; [or] the delivery of work products ... .

*Contingent compensation is especially undesirable ... for municipal advisors ... who are expected to be independent in the provision of advice or services to issuers or in the structuring of municipal securities. ...*

*Payment arrangements that are contingent on the "success" of a financial transaction clearly pose credit and other risks because these arrangements often entangle the opinion or advice required to complete municipal finance transactions, removing its independence. Historically, compensation arrangements in municipal finance transactions that hinged on transactional completion have been associated with poorly structured bond issues ... to the detriment of municipal investors, as well as issuers ... .* [Emphasis added; footnotes omitted.]

I urge the Board to consider requiring the following important disclosures to municipal advisory clients in connection with contingent municipal advisor compensation:

- Contingent compensation presents a conflict of interest, in that it creates a potential motivation to close transactions that should be considered carefully and that may present risks to municipal entities
- The presence of contingent compensation may require the client to monitor the transaction and the advice the client receives from the municipal advisor more carefully than the client might do in the absence of contingent compensation
- The potential conflict of interest may negate the ability of the client to assert claims against the municipal advisor for failure to act solely in the best interests of the client without regard to the financial or other interests of the municipal advisor

- Noncontingent compensation structures are available and should be considered by issuers, with a specific requirement that the municipal advisors offer noncontingent compensation options to clients in the form of hourly compensation, with or without a cap, or fixed noncontingent compensation or both
- Clients are able to pay noncontingent compensation from bond proceeds
- Contingent compensation is a basis to be considered in determining the amount of the compensation and may justify a higher compensation than would be payable in the form of noncontingent compensation

### **Rule G-23 or Rule G-42.**

At present, I am indifferent as to whether the Board should decide to retain Rule G-23 as a separate rule or should fold it into Rule G-42.

The key issue for me is to retain the principal of a complete separation between municipal advisory services and underwriting services.

As discussed in this letter, I also believe that, in this context, the Board could beneficially review Rule G-42 in a number of respects to improve its coverage of actual practices by municipal advisors.

### **My Initial Experience with Rule G-23**

In the late 1970s, I served as General Counsel to the GFOA. At that time, the MSRB was in its initial stages of organization and rule proposal and adoption. Even then, more than 40 years ago, the MSRB recognized that financial advisors to municipal bond issuers had a fiduciary duty to the advisors' clients. This is illustrated by releases by the MSRB in the 1970s and 1980s describing, as long as 40 years ago, the fiduciary character of the relationships between financial advisors and their issuer clients.<sup>27</sup>

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<sup>27</sup> See, e.g., MSRB Filing of Proposed Fair Practice Rules with SEC on Sept. 20, 1977, stating:

*As a financial advisor, the municipal securities professional acts in a fiduciary capacity as agent for the governmental unit, assisting it in determining its debt structure, determining when and under what circumstances to market its securities, and preparing or assisting in the preparation of documents to be used in connection with the sale of its securities. The existence of such an arrangement is evidenced by an agreement, written or otherwise, for the municipal securities professional to render financial advisory services to the governmental unit for a fee or other compensation or in expectation of compensation. ...*

*The role and interests of a securities professional acting as financial advisor to a governmental unit are significantly different from the role and interests of a securities professional acting as an underwriter or as a purchaser in a private placement. For example, as agent for the issuer, a financial advisor would normally seek to achieve the lowest possible interest cost for the issuer, while an underwriter, acting as principal for its own account, would normally want to establish yields which make the securities attractive for resale to others. Other marketing features,*

In my representation of GFOA, when the MSRB proposed an absolute prohibition in Rule G-23 of financial advisors also serving as underwriters to issuer clients, I received a number of communications specifically from issuer officials in the State of Texas who had been told by their financial advisors that the proposal would harm issuers by limiting the advisors from serving as underwriters. One argument was that the advisors knew more about the clients' bonds than did other firms, and therefore, the advisors would be the best underwriters for their clients. I also received a contact from an advisor in the State of Connecticut. I heard from no other issuer officials one way or the other about the proposal.

On the basis of the contacts I received from those issuer officials, I opposed the complete prohibition on behalf of GFOA.

As explained below, based upon additional information I learned later, I now consider that to have been a major error on my part.

In part on the basis of my opposition on behalf of GFOA, the MSRB adopted, instead of the complete prohibition, a requirement that dealers serving as financial advisors first resign, make certain disclosures to their clients regarding conflicts of interest, and obtain written acknowledgements from the clients regarding receipt of the disclosures.

I later discovered, as described below, that the "disclosures" advisors/underwriters provided pursuant to Rule G-23 were made in a perfunctory manner. I also discovered that the "consenting" issuer officials were poorly-equipped to evaluate the subject matter or its significance and had little or no understanding of what they had been told in the disclosures or of what the officials were signing in "consent" documents buried in a mass of other documentation. The subject rarely, if ever, was explained to the issuers' governing bodies, and the issue was not discussed for the governing bodies or the signing officials in a substantive manner. Neither the underwriters nor the bond counsel serving the issuers explained the significance of the issue.

### **Permitting Competitive Bids under Rule G-23**

On the surface, the concept of permitting financial advisors to submit bids in competitive offerings suggests that issuers would benefit from having an additional bidder. What could be the disadvantage?

The argument has been advanced that permitting the additional role would increase the number of bidders in competitive bids to the issuers' advantage.

I suggest respectfully that the asserted "benefit" is illusory.

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important from an underwriting perspective, may conflict with an independent determination of the same matters from the perspective of the issuer.

Commerce Clearing House, Municipal Securities Rulemaking Board Manual Transfer Binder '77-'87 Decisions ¶10,030 at 10,377 (Sept. 20, 1977); see also ¶10,003 referring to "the high level of fiduciary responsibility owed by securities professionals to issuers they advise." [Emphasis added.]

I suggest the following practices discussed below, among others, for careful consideration:

- Use of advisory status as a misleading step toward underwriting
- Structuring bonds for marketing by advisors' underwriting desks, rather than the market as a whole
- Inadequate disclosure and client consent practices regarding the advisors' conflicts of interest and associated risks
- Advisors' division of the market among firms
- Courtesy bids
- Naturally lower levels of bidding due to smaller bond principal

**“Get Yourself Hired as Financial Advisor, Then Switch to Underwriter.”**

After my work with GFOA, my next significant encounters with Rule G-23 arose from my services as an investment banker in the Rocky Mountain Region and in Texas.

One of the first pieces of advice I received from my supervisors as an underwriter was to “Get yourself hired as financial advisor, then switch to underwriter.” Indeed, I found that was a standard practice followed by many underwriting firms. I declined to follow that advice.

These underwriters and their competitors did not regard the financial advisory role as a fiduciary role, but rather as a stepping stone to gaining retention as underwriters while posing as advisors to the issuers.

The disclosures required by Rule G-23 were considered to be perfunctory, if they were made at all. Indeed, when I pointed out to one issuer that its financial advisor, in switching to underwriter, had failed to make the required disclosures, the bankers in my own firm became angry that the subject even had been raised.

This former practice under Rule G-23 as it formerly existed should be a specific concern if the Rule (or corresponding provisions of Rule G-42) were to permit municipal advisors to underwrite bond issues, even in competitive bid settings.

**The Problem of Secretive “Disclosure,” and the Role of Bond Counsel.**

I learned then, and throughout my career, that the issuers' acknowledgements of receipt of Rule G-23 disclosures were made typically in a form buried in stacks of multiple closing documents organized and presented to issuer officials by bond counsel. Often, the closing documents consisted of hundreds of pages that overwhelmed many issuer officials.

Sometimes, the language was part of larger, lengthy and complex omnibus documents. The disclosures were generally not even mentioned orally, except at times to “explain,” but only in a

general sense, that the resignations were for the issuers' benefit. Issuer officials simply were told that the change in roles was made because the advisors' firms were the best equipped and most knowledgeable firms to serve as underwriters in the transactions. Issuer officials routinely executed the acknowledgments along with many other documents in an atmosphere of rushing to assemble everything quickly for the closing (through which transaction participants would receive their contingent fees).

Beyond the obscure "disclosure," there was no effort by any party, including the financial advisors/underwriters and the issuers' own bond counsel, to point out the conflicts of interest involved in the resignation and the switch in roles from financial advisor to underwriter. No one questioned or challenged the financial advisors' assertions that the resignations were in the issuers' interest. Bond counsel, whose fees also often depended on completion of the closing, remained silent. Bond counsel had no desire to alienate the underwriter (f/k/a the financial advisor) from whom bond counsel frequently obtained business as underwriter counsel in other transactions.

Thus, the resignations occurred with the technical, but generally unknowing, acknowledgement of issuers, often small and infrequent issuers that are so pervasive in the municipal bond market.

This former practice under Rule G-23 as it formerly existed should be a specific concern if the Rule (or corresponding provisions of Rule G-42) were to permit municipal advisors to underwrite bond issues again, even in competitive bid settings.

### **"What Can My Firm Sell?"**

I found that some dealer firms routinely presented themselves as "advisors" with the issuers' best interests at heart. For example, staff of one influential statewide dealer organization routinely referred to its members as "our financial advisors," even though bond underwriting was how the members of that organization typically made their money.

The financial advisors in that atmosphere focused on what their own firms could sell as underwriters, not on what bond structures were in the best interests of the issuer clients.

Thus, it was a common practice for the front-line bankers structuring the transactions to consult with their own underwriting desks about bond structural issues with the firm's own inventory and sales capabilities as the focal points.

The interests of other underwriting firms often would be ignored completely. Those other firms customarily would not express any interest in the bond issues because they knew they could not obtain the business. Instead, those other firms focused on their own transactions with their own issuer clients in which the firms switched roles from financial advisors to underwriter.

This former practice under Rule G-23 as it formerly existed should be a specific concern if the Rule (or corresponding provisions of Rule G-42) were to permit municipal advisors to underwrite bond issues, even in competitive bid settings.

**Avoidance of Competitors and Competition among Financial/Municipal Advisors.**

I also found that a definite noncompetitive attitude was reflected in market practices in which financial advisors would enter into contracts that automatically renewed upon reaching their term and that continued in existence generally even when the financial advisors resigned to underwriter specific bond issues.

Although state law may have prevented interference in *existing* contracts, it was my experience as an underwriter that financial firms would refrain from contacting clients of other firms, even if only seeking to be considered *once the then-current contracts with other firms reached their term*. Such contacts were considered to be “unethical,” with the result that competition among financial advisors and underwriters was severely limited to the disadvantage of municipal issuers. I recall expression of views strongly against making contacts with other firms’ clients. There were concerns that the financial advisors of those clients, when functioning as underwriters, would refrain from selling bonds to the contacting firms in a role as selling dealers during bond offering periods and from trading bonds in the secondary market. A senior underwriting official called it “shooting yourself in the foot.” In that atmosphere, municipal issuers were denied the benefits of competition.

This practice under Rule G-23, as it formerly existed, should be a specific concern if the Rule (or corresponding provisions of Rule G-42) were to permit municipal advisors to underwrite bond issues again, even in competitive bid settings. I doubt seriously whether competition could flourish even in competitive bids when advisors/underwriters structure bonds for their own underwriting desks and investor clientele.

Rather than increasing the number of bids issuers would receive, in many instances, I would expect that, by permitting advisors to bid as underwriters, effective competition would be reduced.

I note that, even today, a similar anticompetitive practice by nondealer municipal advisors belonging to the National Association of Municipal Advisors (NAMA) should also be a concern. NAMA states, as an “ethical” obligation of municipal advisors pursuant to NAMA’s **CODE OF PROFESSIONAL CONDUCT AND ETHICS**, that:

Municipal Advisors shall meet or exceed professional standards related to business conduct and strive to: ... *Respect existing contracts and relationships of clients and prospective clients with other professionals, including other Municipal Advisors.* [Emphasis added.]

Putting aside antitrust implications of an “ethical” requirement that discourages municipal advisors from contacting issuers in *relationships* (not merely contractual relationships) and even *prospective relationships* with other municipal advisory firms, NAMA’s Code presents significant issues for consideration by the Board and the Commission, as well as the Government Finance Officers Association. Municipal bond issuers should be able to receive the benefits of a fully competitive market. NAMA’s **CODE OF PROFESSIONAL CONDUCT AND ETHICS**, if practiced literally, represents a restraint on trade that should not be permitted.

If NAMA's members consider this practice to be "ethical," then dealer advisors are equally likely to divide the market among themselves as they had done previously.

The potential for this practice under Rule G-23 as it formerly existed should be a specific concern if the Rule (or corresponding provisions of Rule G-42) were to permit municipal advisors to underwrite bond issues again, even in competitive bid settings.

### **Courtesy Bids**

Another issue is that of potential cooperation among firms to submit courtesy bids. Based upon my experience as underwriter, and hearing conversations within firms, I do not doubt that such cooperation can exist, given a climate in which firms mutually assist each other in maintaining client relationships through division of the market.

Firms that agree not to compete among themselves in order to protect each other's client relationships will readily engage in such practices.

I firmly believe that the vast majority of firms and individuals involved in the municipal securities market are honorable people who seek to conduct business in an ethical manner. Nevertheless, the history of actions by some municipal advisors and underwriters affecting competition adversely in relation to LIBOR pricing, investment contract bidding, land-based securities, sales of derivatives to unsophisticated issuers, auction rate securities, pennyng and, as most recently alleged, but not yet proved, the VRDO market indicates that concern regarding courtesy bidding in competitive bond underwriting is not at all far-fetched.

### **Smaller Bond Issues and Lower Number of Bids**

It is not surprising that smaller issuers and smaller bond issues may attract a smaller number of bids.

In smaller bond issues, financial advisors are unlikely to expend as much effort to attract bids as they do in larger more visible bond issues. A \$5 million or \$10 million bond issue is unlikely to provide the same motivation to a financial advisor to seek bids from multiple underwriters as is a \$100 million bond issue.

I question whether a change to permit financial advisors to resign in order to submit bids in competitive offerings will result in improved outcomes for municipal entities.

In my experience as a financial advisor, smaller and infrequent issuers had no difficulty in attracting interest from multiple firms. I often rejected dealer proposals and sought and obtained superior competing dealer bond purchase proposals, even for issuers that rarely entered the market or were new to the market.

If issuers are not receiving a sufficient number of bid submissions or underwriting proposals, then I suggest that the issuers' advisors are not providing suitable services to their municipal entity clients. In other words, the lower number of bids attracted by municipal

advisors in smaller bond issues is likely due to a failure to work as hard as necessary to produce more bids.

**“You Have No Claim. As Underwriter, We Had No Duty to Inform or Warn You.”**

In my litigation consulting experience, I have encountered a number of arguments advanced to protect underwriters after they had already served as financial advisors.

One such argument was that, because the financial advisor had resigned to serve as underwriter, the advisor no longer owed a responsibility to provide advice in the best interests of the municipal entity client. That argument was advanced in connection with a proceeding challenging an advisor’s advice provided during the advisors’ service as advisor. The argument was that the switch in roles resulted in a lower level of protection for the issuer with the issuer’s purported full consent.

This practice under Rule G-23 as it formerly existed should be a specific concern if the Rule (or corresponding provisions of Rule G-42) were to permit municipal advisors to underwrite bond issues again, even in competitive bid settings.

In particular, if dealer (or nondealer) financial advisors are permitted to resign in order to serve as underwriters or placement agents, the Board must define whether advisors’ fiduciary responsibilities survive the change in roles, and if so how and to what degree.

**Bond Banks and Similar Vehicles.**

The principles of Rule G-23 need improvement in certain respects, regardless of whether the Rule survives or is combined with Rule G-42. One area deserving additional consideration is when advisors assist issuer clients in placing bonds with bond banks or similar vehicles. The Board’s current re-examination of Rule G-23 offers an opportunity to consider this subject.

One area to consider is the role of underwriters of bond banks. I do not object to allowing financial advisors to assist municipal entity clients in borrowing directly from bond banks or other similar vehicles in which financial advisors do not have a financial interest. I do have a concern, however, relating to bond banks when financial advisors do, in fact, have financial interests in those entities, disclosed or undisclosed.

In my litigation consulting, I became aware that Rule G-23 allows financial advisors to continue to work as advisors on bond bank financings for municipal entities and then to serve as underwriters of the bond bank’s bond issues through which the municipal entities are borrowing. A bond bank is not the “issuer” served by the financial advisor *as advisor*, and so Rule G-23 does not appear to reach this conflict of interest. This practice inherently involves the same or a closely similar conflict of interest to serving as underwriter for the municipal entity’s bonds directly.

In other words, the financial advisor has a conflicting motivation to earn two fees—one as financial advisor to the municipal entity and the other as underwriter of the bonds issued by the bond bank to which the advisor steered the issuer for financing. The issuer’s participation in the



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bond bank's pool increases the total par amount of the bond bank's bonds and, thereby, the underwriting compensation received by the firms, including the advisor, underwriting the bond bank's bonds.

That is a conflict of interest that should be prohibited, just as direct underwritings and placements of the issuer's bonds are prohibited.

### **Bonds of Obligated Person Clients**

Obligated persons are not the governmental "issuers" of the conduit bond issues in which the obligated persons receive financing.

It does not appear that Rule G-23, as framed at present, protects obligated person clients of financial advisors who may wish to underwrite the governmental issuers' bonds. Although pursuant to SEC Rule 131 and 3b-5, obligated persons are considered to be "issuers" of loan, lease and installment agreements into which the obligated persons enter in connection with conduit bond issues, the obligated persons may not be "issuers" for purposes of Rule G-23. Certainly, it is not clear.

At the time Rule G-23 was first adopted, conduit bonds, although issued to some extent at the time, were not as prevalent as they are today. This change in market conditions should be recognized.

Obligated person clients of municipal advisors/financial advisors should have the same protections pursuant to Rule G-23 (or Rule G-42) as do municipal entity advisory clients.

### **Wide Range of Conflicts of Interest Relevant to Rule G-42**

In my litigation consulting, I have become aware of a wide range of conflicts of interest of municipal advisors that were not generally identified at the time of the original adoption of Rule G-42.

I suggest respectfully that the Board review both Rule G-23 and Rule G-42 carefully to provide guidance and assistance to municipal advisors regarding disclosure of, and obtaining effective client consents regarding, these and other previously unanticipated conflicts of interest and associated risks.

The following is a summary of certain previously unidentified municipal advisor conflicts of interest:

- *Pre-election conflicts of interest*

In some bond issues involving bond elections, for example in school district and other voter approved bond issues, municipal advisors are offering simultaneously to municipal entities complex fee structures consisting of multiple tiers of compensation arrangements. This occurs, for example, in connection with some California general

obligation bond issues. The first tier of such compensation is a fee contingent on whether the issuer decides to conduct a bond election and the election is successful.

This form of contingent compensation creates a motivation for the advisor to engage in sales activities, as opposed to providing unbiased advice, both with respect to the issuer's calling an election and again with the electorate as to how to vote. The advisor has a motivation to convince the municipal entity to issue bonds and to convince the electorate to approve the bonds, as opposed to providing unbiased advice regarding *whether* to issue bonds at all or what principal amount, whether a proposed structure is the best alternative, whether a proposal needs modification that may introduce delay, or whether a proposed structure should be investigated further.

To receive payment of this fee, the advisor must "sell" the issuer, generally the issuer's governing body, and then the electorate, on the need or desirability of bond issuance.

Unless the municipal entity decides to issue bonds (and the electorate approves), the advisor will not be paid this contingent fee, despite what may be months of work creating and making presentations and attending meetings, often at locales far removed from the advisors' offices, purporting to analyze whether the issuer could benefit from and pay a bond issue appropriately. For example, an advisor may tilt a presentation either for or against bond issuance or a particular bond structure or bond size depending on how a voter survey sponsored or conducted by the advisor is conducted or interpreted to an issuer and its governing body.

These are complex factual settings about which there is little discussion. I believe these settings deserve further careful consideration.

The bottom-line issue for the Board to consider is whether municipal advisors fulfill their fiduciary duties by functioning as sales personnel in promoting bond issuance. If so, the fiduciary duty may be rendered meaningless.

- *Bond election conflicts of interest*

Again, having convinced the issuer's governing body to call an election, in order for the municipal advisor to receive the first-tier contingent fee, the advisor also must convince the electorate to approve issuance of the bonds. Like the issuer's governing body, at this stage the electorate is functioning as a key element of the issuer's governance structure. It likely would violate the advisor's fiduciary obligation to mislead the electorate, and it certainly would be unfair within the scope of Rule G-17.

In connection with bond elections, some municipal advisors obtain separate retention *as advocates* by election campaign committees that favor bond issuance. Remember that these same "advisors" purportedly had a fiduciary duty to their municipal entity clients to provide sound balanced advice regarding *whether* even to call a bond election. Supposedly, the advisors are required, after the election, once again to provide sound balanced advice regarding completion of bond issuance.

During the election, however, which is sandwiched between pre- and post-election service to the municipal entity client, the advisors now may be providing to bond election committees—as a loss leader—in-kind below cost (taking into account staff salaries) services as advocates for bond issuance. That is because election committees consisting of local volunteers relying on citizen contributions commonly pay the advisors at an extremely low fixed rate of compensation that may be only a few hundred, or perhaps thousand, dollars, in contrast with the typically much more substantial compensation the municipal advisors receive in connection with bond issuance in the tens of thousands of dollars. This is the second-tier of some advisory fee structures.

The low second-tier fixed election compensation may be essentially for reimbursing a portion of the advisor's costs in traveling to the locality and providing campaign assistance and materials, ignoring the in-kind contribution of municipal advisor officer and staff salaries during the election campaign.

This retention places an advisor in the position of directly *advocating* the bond election, not in the position of *advising* either the issuer's governing body or the electorate about whether the issuer could beneficially issue bonds.

In my litigation consulting, I have seen evidence of municipal advisors sending senior officers to a locality to coordinate election campaign activities, providing campaign training and literature, coordinating telephone activities, and even engaging in explicit campaign activities as advocates, such as holding campaign signs on street corners. The issuers may be located at a distant location from the advisors' offices, requiring significant travel, lodging and meal expenses. The advisors' officers may work intensively for many days in order to achieve a successful election.

Clearly, in such circumstances, the advisors are not providing unbiased advice.

Recall that the advisor will not be paid pursuant to the contingent first-tier pre-election compensation described above that the advisor is to receive from the municipal entity, unless the electorate approves the bond issuance. Where is the balance in the advisors' advice now that the advisors are unabashed sales personnel in relation to the electorate?

Could not third parties, as is sometimes the case already, provide the election advocacy services, so that the municipal advisors—fiduciaries—are able to remain unbiased?

As noted, all of this election work may generate a very low rate of fixed compensation payable by the campaign committee. It creates a motivation to convince the electorate to approve the bond issue, with typical election campaign tactics, so the advisor will be able to make up for the expensive in-kind contribution of labor to the election campaign as a loss leader.

I have seen bond election proponents threaten to cease their support for bond issuance without withdrawal of literature prepared by an advisor that the proponents deemed false and misleading. If those allegations are true, misleading campaign literature cannot be consistent with the fiduciary duty of municipal advisors, and once again, it certainly would be unfair. Municipal advisors need to be cautioned about these possibilities.

I reiterate that, at this point, the electorate has an important role, as an internal element of the issuers' governance structures, to approve the bond issues. Without positive action by the electorate, the issuers will not be able to issue the bonds. In this sense, voters have certain similarities to shareholders of private companies who are protected by proxy and other rules with respect to significant corporate actions, such as charter amendments, mergers and acquisitions.

If an election is successful, it will lead to the advisor's receipt of the pre-election contingent compensation and, in addition, assuming the bonds are issued, a third-tier additional post-election contingent compensation upon the closing of one or more bond issues.

Advisors are unlikely to disclose to municipal entity clients any of these conflicts of interest or the associated risks that the municipal entity may be issuing bonds needlessly or excessively.<sup>28</sup> Rule G-42 does not recognize the diversity of these conflicts.

- *Multiple fee conflicts of interest*

Another form of compensation—the third tier—reflecting conflicts of interest is one that may result in the payment of multiple contingent closing fees to a municipal advisor, if the advisor cannot issue and close, in a single bond issue, all of the principal amount of bonds the advisor recommends during the pre-election period. The fee structure is expressed as "\$X per bond issue."

The advisor expects to collect the full amount of the fee in each of the multiple bond issues, rather than apportioning the fee among bond issues.

This form of contingent compensation creates a motivation for the advisor to recommend the issuance of an aggregate principal amount of bonds that cannot be issued at one time. That is because the property values within the issuer's jurisdiction may not support that full amount of bonds due to state law limitations on tax rates or bond amounts. If, however, as often occurs, property values increase in the future, additional bond issues may be issued at a later date and the advisor may be able to

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<sup>28</sup> See GFOA, **RECOMMENDED PRACTICE—SELECTING FINANCIAL ADVISORS** (2008); GFOA's **BEST PRACTICE—SELECTING AND MANAGING MUNICIPAL ADVISORS** (Feb. 2014) ("Generally, municipal advisory fees should not be paid on a contingent basis to remove the potential incentive for the municipal advisor to provide advice that might unnecessarily lead to the issuance of bonds.")

receive an additional contingent closing fee at that later date without having to solicit the electorate again. So, like a construction contractor discussing potential home improvements with the homeowner, the advisor may “suggest” to the issuer that the issuer may wish to undertake additional improvements that could be included in the principal amount of bonds submitted to the electorate for approval. Sometimes, multiple bond issues may be appropriate for the issuer, of course. The point is for the issuer to be made fully aware of the advisor’ conflict of interest and associated risks.

In making its presentation to the issuer, the advisor may manipulate election survey results and other information so as to convince the municipal entity that it will be able, based upon a tax rate recommended by the advisor, to finance the costs of projects additional to the municipal entity’s immediate needs

Thus, the first-tier pre-election phase of contingent compensation, and the election campaign committee’s low second-tier fixed compensation as a loss leader become intertwined with the advisor’s expectation of multiple third tier post-election contingent closing fees.

The municipal entity would be much better off if it received unbiased advice regarding the need for, planning, sizing, structuring and issuance of bonds, instead of advice based upon the multiple forms of contingent compensation about which the municipal entity is not informed and is not offered any choice.

The essence of these issues, which may involve appropriate actions by advisors, is that advisors be fully aware of and discharge responsibly their fiduciary and fair dealing roles.

- *Dependence on underwriters for bond structuring*

There are other unfortunate facts and circumstances in which a municipal advisor becomes dependent upon underwriters for assistance in modeling bond issues. For example, shockingly I have seen facts and circumstances in which a very active advisor is unable to operate municipal finance software sufficiently to provide unbiased advice to the advisors’ issuer clients regarding bond structure alternatives. The advisor, although owning the necessary software, is aware (but does not disclose to the issuer) that the advisor simply is unable to prepare reliable alternative bond structuring scenarios for the client. Certainly, this presents significant issues of competency. Instead, the advisor must rely upon underwriting firms to produce bond structuring models. The underwriting firms, of course, are concerned with their own interests, including obtaining retention by the issuer and structuring bonds they are best able to sell.

In this atmosphere, the municipal advisor is unable to make unbiased recommendations to the advisor’s municipal entity clients regarding whether to utilize competitive bids or negotiated sales. In the event of negotiated sales, which are virtually inevitable in a context in which the advisor is not competent to operate the

software appropriately on behalf of the advisor's clients, the advisor also inevitably will recommend retention by the issuer clients of the specific underwriters upon whom the advisor is dependent.

### **Competitive Bids vs. Negotiated Sales**

I understand that proposals have been made to the Board to expand competitive bidding in Rule G-23 by allowing dealer financial advisors to serve as underwriters.

The issue of competitive bidding versus negotiated sales is one much debated in the municipal securities market. Despite the controversy, there is definitive evidence that competitive bidding provides superior pricing in certain definable circumstances.

Bond pricing is extremely important to municipal bond issuers. Bond pricing is a core role and responsibility of municipal advisors functioning as financial advisors. I suggest respectfully that the Board reinforce consideration and information regarding advisors' key responsibilities in this area. Simply because a number of differing types of financial firms have significant competing financial interests in this subject matter is not a reason to avoid responsibility.

I am not someone who believes that competitive bidding always is best. I believe there are good arguments for negotiated sales in certain definable circumstances in order to allow an underwriter to be involved intimately with the issuer so as to investigate and appreciate to a greater extent the subtleties of the circumstances surrounding certain bond issues.

The following exemplify such circumstances:

- The issuer is new or unfamiliar to the market
- The issuer has experienced significant financial difficulties
- The issuer's reputation has suffered in the market, perhaps due to poor financial management or to a failure to honor commitments (such as failing to appropriate funds in an appropriation-based bond issue)
- The bonds are low rated, such as below BBB+/Baa1
- The offering is unusually complex
- The bonds are not commoditized bonds<sup>29</sup> with structures familiar to the market
- The offering presents unusual circumstances requiring especially careful analysis and disclosure

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<sup>29</sup> By "commoditized" bonds, I mean bonds that have a sound, credit-worthy structure familiar to and well-accepted in the market.

There is a substantial body of unbiased peer-reviewed academic research, conducted and published repeatedly over many years, and even decades, supporting the superior pricing municipal issuers can receive in certain definable competitive bid circumstances. There also is contradicting research, generally funded by industry parties with financial interests in challenging those unbiased academic results.

Some municipal advisors do not utilize competitive bids simply because they do not know how to do it. Others do not utilize competitive bids because they want to maintain relationships with certain underwriters—a conflict of interest. Those motivations do not place the best interests of the advisors' clients first.

Although the task is difficult and not for the faint-hearted, I believe that the Board should hold municipal advisors' feet to the fire on this issue that means so much in terms of affordability and cost savings to municipal entities, especially smaller, unsophisticated and financially-stressed issuers.

Part of the problem is that market participants debating this issue generally approach it on an all or nothing basis. Those are extreme positions that fail to differ among bond issues. I do recognize that there are individual offerings, and even periods in the market when competitive bids may not always be superior, but as a general rule the superior pricing consistently holds true, and municipal advisors, as financial experts should be required to exercise their professional judgment appropriately.

Under Rule G-23 and Rule G-42, financial/municipal advisors should be recommending competitive bids, except in definable circumstances, such as those I have outlined above, or unless they are able to demonstrate otherwise that negotiated bids are likely to produce superior results in a specific bond issue.

If an offering is one of essentially commoditized bond structures issued by a financially-sound issuer familiar to the market and if the bonds are rated BBB+/Baa1 or higher, then there should be a bias in favor of competitive bidding barring demonstrable circumstances. This is particularly true, for example, for tax-supported bonds and bonds payable from revenues of well-established utility systems with an established positive history of operations.

### **Role of State Law and Common Law.**

The Dodd-Frank Act imposed the statutory federal fiduciary duty on municipal advisors for purposes of federal law.

Some municipal advisors do not recognize that fiduciary duties also may apply to them under state or other laws, whether statutory or common law.

In the municipal securities market, many financial advisors recognized long prior to the enactment of the Dodd-Frank Act that they had fiduciary duties to municipal bond issuers. This was made clear in enforcement proceedings and judicial decisions dating back to the 1990s. For example, the SEC and the United States Department of Justice enforced fiduciary duties of

financial advisors and obtained favorable decisions in federal district courts and administrative law tribunals and in the 1<sup>st</sup>, 9<sup>th</sup>, 10<sup>th</sup> and 11<sup>th</sup> federal circuit courts.<sup>30</sup>

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<sup>30</sup> See, e.g., *United States v. Ferber*, 966 F. Supp. 90 (D. Mass. 1997) (criminal case; failure to disclose to sophisticated clients financial advisor's interest in recommended interest rate swaps with third party; discusses state law); *United States v. deVegter*, 198 F.3d 1324 (11<sup>th</sup> Cir. 1999) (indictment sufficiently alleged fiduciary duty; failure to disclose to sophisticated client payments from underwriter in connection with financial advisor's ranking of proposing underwriters); and *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp. 2d 985 (D. Ariz. 1998) (motion to dismiss denied; SEC's complaint alleged misstatement in tax certificate, failure to disclose role as principal, excessive markup, profit from sale of recommended escrow investments, and potential loss of tax exemption; discusses state law); *SEC v. Cochran, et al.*, 214 F.3d 1261 (10<sup>th</sup> Cir. 2000) (reversed judgment in favor of defendants and remanded case; failure to disclose to client receipt of payments from seller of recommended investments; cites fiduciary duty of agents under state law); and *In the Matter of Wheat First Securities, Inc., et al.*, SEC Initial Decision Rel. No. 155 (Dec. 17, 1999), *aff'd.* in SEC Rel. No. 34-48378 (Aug. 20, 2003) (Commission Opinion) (Administrative Law Judge and Commission decisions—failure to disclose role of lobbyist in financial advisor's gaining retention by issuer despite representation that no lobbyist had been used). But see *U.S. v. Cochran*, 109 F.3d 660 (10<sup>th</sup> Cir. 1997) (reversing criminal conviction for nondisclosure of remuneration the defendant received from an investment provider based on evidence that one client did not rely on the defendant for advice regarding investments and another was not shown to have been harmed); *In the Matter of Public Finance Consultants, Inc., et al.*, SEC Initial Decision Rel. No. 274 (Feb. 25, 2005) (Administrative Law Judge decision—financial advisor's scope of services approved by issuer's Board of Directors did not include providing advice on disclosure in Official Statement).

See also *In the Matter of Daisy Systems, Inc.*, 97 F. 3rd 1171 (9<sup>th</sup> Cir. 1996) (financial advisor to sophisticated corporate client would be presumed to be a fiduciary under state law, if served as agent; confidential relationship cited as a factor); and *Miami v. Benson*, 63 So.2d 916 (Fla. 1953) (against public policy under state law for financial advisor to serve as underwriter).

See also settled pre-Dodd-Frank Act SEC enforcement actions against financial and investment advisors to municipal entities and against advisors' officers, often applying state or other laws in *In the Matter of Lazard Freres & Co., LLC, et al.*, SEC Rel. No. 34-36419 (Oct. 26, 1995) (financial advisory firm breached fiduciary duty to sophisticated clients by failing to inform the clients of advisor's interest in interest rate swaps recommended with third party); *SEC v. Ferber*, SEC Lit. Rel. No. 15193 (Dec. 19, 1996) (financial advisor breached fiduciary duty to sophisticated clients by failing to inform the clients of advisor's interest in interest rate swaps recommended with third party); *In the Matter of deVegter*, SEC Rel. Nos. 33-8645, 34-53009, IA-2465, IC-27196 (Dec. 22, 2005) (failure to disclose to sophisticated client payments from underwriter in connection with financial advisor's ranking of proposing underwriters); *In the Matter of Irby*, SEC Rel. No. 34-39362 (Nov. 26, 1997) (although not informed of payments by underwriter to senior officer, junior officer of financial advisor aided and abetted violation by altering ranking of proposing underwriters upon direction by supervisor); *SEC v. Stifel, Nicolaus & Co., Inc.*, SEC Lit. Rel. No. 14587 (Aug. 3, 1995) (failure to disclose to client and misstatements regarding receipt of payments from seller of recommended investments; jeopardy to tax-exemption of bond interest); *SEC v. Cochran, et al.*, SEC Lit. Rel. No. 16063 (Feb. 17, 1999) (failure to disclose to client and misstatements regarding receipt of payments from seller of recommended investments; jeopardy to tax-exemption of bond interest); *In the Matter of Nelson*, SEC Rel. Nos. 33-7635, 34-40984 (Jan. 27, 1999) (junior officer of financial advisor prepared letter to inform client of payments received in connection with recommended investments, but supervisor failed to send the



As stated by Robert Fippinger in his authoritative treatise, **THE FEDERAL SECURITIES LAW OF PUBLIC FINANCE**:

The statutory fiduciary duty is a federal standard that applies *in addition to any state law* impositions of a fiduciary duty ... .

[R. Fippinger, **THE FEDERAL SECURITIES LAW OF PUBLIC FINANCE**, Ch. 11, Municipal Advisor Regulation at §11:1.1, p. 11-9 (Practising Law Institute, New York, Rel. #6, 9/17).] [Emphasis added]

In Supplementary Material .08 to its Rule G-42, the Board recognizes the application of state law fiduciary duties and defers to stricter state law and other requirements, as follows:

**.08 Applicability of State or Other Laws and Rules.** Municipal advisors may be subject to fiduciary or other duties under state or other laws. *Nothing contained in this rule shall be deemed to supersede any more restrictive provision of state or other laws* applicable to municipal advisory activities. ... [Emphasis added.]

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letter despite informing junior officer that supervisor would take care of it; junior banker aided and abetted violation by not informing client); *In the Matter of Vonfeldt*, SEC Rel. No. 34-41697 (Aug. 3, 1999) (despite warning signs, supervisor failed to investigate firm's receipt and nondisclosure of payments from seller of recommended investments; jeopardy to tax-exemption of bond interest); *In the Matter of Milbrodt*, SEC Rel. Nos. 33-7455, 34-39121 (Sept. 24, 1997) (lack of expertise and inadequate due diligence to support purported independent expert report prepared for issuer; failure to disclose relationship with recommending underwriter); *In the Matter of Allen*, SEC Rel. Nos. 33-7456, 34-39122 (Sept. 24, 1997) (lack of expertise and inadequate due diligence to support purported independent expert report prepared for issuer; failure to disclose relationship with recommending underwriter); *SEC v. Black, et al.*, SEC Lit. Rel. No. 15591 (Dec. 15, 1997) (investment advisor's alleged solicitation and mismanagement of school district and other governmental entity funds in connection with collateralized investment agreement and misrepresentations regarding agreement); *SEC v. Salema, et al.*, SEC Lit. Rel. No. 14421 (Feb. 23, 1995) and *SEC v. Rudi, et al.*, SEC Lit. Rel. 15202 (Dec. 30, 1996) (individual financial advisors and firm received kickbacks from underwriter paid through a finder); *In the Matter of William R. Hough & Co.*, SEC Rel. Nos. 33-7826, 34-42634 (Apr. 6, 2000) (failure to disclose interest in recommended escrow investments; jeopardy to tax-exemption of bond interest; state law cited); *In the Matter of Rauscher Pierce Refsnes, Inc., et al.*, SEC Rel. Nos. 33-7844, 34-42644, IA-1863 (Apr. 6, 2000) (failure of financial advisor and individual officer to disclose role as principal, excessive markup, profit from sale of recommended escrow investments, and jeopardy to tax-exemption of bond interest); *In the Matter of Lazard Freres LLC*, SEC Rel. 33-7671, 34-41318 (Apr. 21, 1999) (failure to disclose excessive markups in connection with escrow investments, reducing refunding savings to the bond issuer; state law cited); *In the Matter of O'Brien Partners, Inc.*, SEC Rel. Nos. 33-7594, 34-1772 (Oct. 27, 1998) (failure to make full disclosure of, and misrepresentation in connection with, interest in recommended escrow investments; state law cited); *In the Matter of Arthurs Lestrangle & Co., Inc. et al.*, SEC Rel. Nos. 33-7775, 34-42148 (Nov. 17, 1999) (failure to make full disclosure of interest in recommended escrow investments and related fee-splitting); and *In the Matter of Reger, et al.*, SEC Rel. No. 33-7973 (Apr. 23, 2001) (failure to disclose payment arrangement in connection with selection of broker-dealer to provide escrow investments; jeopardy to tax-exemption of bond interest).

The Board also observed this distinction in Rule G-42, Supplementary Material .14 **Principal Transactions**, regarding principal transactions between municipal advisors and municipal entities, stating:

This paragraph .14 shall not be construed as relieving in any way a municipal advisor from acting in the best interest of its municipal entity clients, *nor shall it relieve the municipal advisor from any obligation that may be imposed by other applicable provisions of the federal securities laws and state law.* [Emphasis added.]

Municipal advisors recognize the applicability of state law requirements. For example, the **CODE OF PROFESSIONAL CONDUCT AND ETHICS**, of the National Association of Municipal Advisors states that:

In addition to federal regulations, Municipal Advisors must follow all state and local laws and codes that apply in the jurisdiction where they practice. In the event of a conflict in law or regulation, NAMA members must comply with the more strict law or regulation.

The Board may wish to continue to observe these distinctions in order to inform the market appropriately. This is especially apt in connection with Rule G-23, since, in addition to requirements imposed by the Rule, state or other laws may impose additional fiduciary responsibilities on municipal advisors/financial advisors.

I note also that state common law may (and likely does) impose a fiduciary duty on municipal advisors to obligated persons. This is another area in which municipal advisors could benefit from explicit guidance by the Board.

### **Placement Agents and Remarketing Agents.**

The Dodd-Frank Act amended Section 15B of the Securities Exchange Act of 1934 to impose a fiduciary duty on municipal advisors to municipal entities for purposes of federal law. In SEC Release No. 34-70462 (Nov. 12, 2013), the Securities and Exchange Commission interpreted the term “municipal advisor” to exclude underwriters engaged in underwriting activities. The Commission extended that exclusion to placement agents.

In doing so, however, the Commission observed that “a placement agent may have other duties, including a fiduciary duty to its client, that arise as a matter of common law or another statutory or regulatory regime.”<sup>31</sup> The same logic would apply to other agents for municipal entities and obligated persons, as well, such as remarketing agents.

Likewise, the MSRB has observed that state law may place a fiduciary duty on placement agents, even when federal law does not do so. For example, the Board stated in MSRB Notice 2012-38, *Guidance on Implementation of Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities* (July 18, 2012), that underwriters are

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<sup>31</sup> SEC Rel. No. 34-70462, 78 FR 67468, at 67515, n. 628 (Nov. 12, 2013).

required to disclose to municipal entities that the underwriters do not have a fiduciary duty to the municipal entities.

The Board added, however, that:

In a private placement where a dealer acting as placement agent takes on a true agency role with the issuer and does not take a principal position (including not taking a “riskless principal” position) in the securities being placed, the disclosure relating to an “arm’s length” relationship would be inapplicable and may be omitted *due to the agent-principal relationship between the dealer and issuer that normally gives rise to state law obligations*— whether termed as a fiduciary or other obligation of trust. [Emphasis added.]

Again, the same logic would apply to remarketing agents.

In other words, the agency relationships of placement agents and remarketing agents may give rise to fiduciary duties under state law. In my experience, some placement agents and remarketing agents may rely solely on the SEC release, and may overlook the potential application to them of fiduciary duties under state law.<sup>32</sup>

The Board may wish to continue to observe these distinctions, as well as the distinctions noted above between federal and state law as applicable to municipal advisors, in order to inform the market appropriately.

### **Nondealer Municipal Advisors Serving as Dealers.**

Rule G-23 applies to dealers. Many municipal advisors are not dealers or at least are not registered as dealers.

It is readily apparent, however, that some municipal advisors continue to believe that they are able to serve as brokers and dealers in placing their municipal entity clients’ securities directly with investors, although the advisors are not registered as such. These advisors may openly solicit and identify bond purchasers, receive compensation contingent upon completion of the offering, negotiate bond terms with the investors, and undertake other roles and responsibilities of underwriters and placement agents.

In particular, municipal advisors’ receipt of contingent compensation in the context of identifying potential investors in negotiated bond offerings, selling bonds directly to investors, and negotiating bond terms directly with investors presents especially troublesome issues. As noted earlier, the contingent compensation radically increases the pressures on municipal

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<sup>32</sup> Regarding fiduciary duties under state law, see generally, the **RESTATEMENT OF AGENCY THIRD**, especially Chapter 8; Tamar Frankel, **LEGAL DUTIES OF FIDUCIARIES—DEFINITIONS, DUTIES AND REMEDIES** ( Fathom Publishing Co. 2012) and **FIDUCIARY LAW** (Oxford University Press 2011); and Mecham, **A TREATISE ON THE LAW OF AGENCY INCLUDING NOT ONLY A DISCUSSION OF THE GENERAL SUBJECT, BUT ALSO SPECIAL CHAPTERS ON ATTORNEYS, AUCTIONEERS, BROKERS AND FACTORS** (reprinted by Wentworth Press 2016).

advisors to complete transactions, as opposed to providing optimal advice solely in the best interests of the advisors' clients as to whether a transaction is wise, is the best alternative, needs modification that may introduce delay, or should be investigated further.

Although the Board and the Commission both have spoken to this issue on a number of occasions,<sup>33</sup> it is inevitable that, someday, there will be very surprised municipal advisors who discover, despite the warnings, that they cannot function in this manner.

The process of combining or coordinating Rule G-23 with Rule G-42 should not overlook this not uncommon compliance failure by some nondealer financial/municipal advisors. Although the advisors cannot avoid compliance with Rule G-23 simply by failing to register as broker-dealers, the advisors should be brought explicitly into regulatory coverage.

### **Control Persons and Aiders and Abettors**

Municipal advisor personnel, as well as municipal advisor firms, are subject to qualification, registration and regulation by the Board and the Commission and to enforcement by the Commission. Some municipal advisor personnel are supervisors or owners (*e.g.*, key shareholders or partners, even if not active supervisors) subject to additional regulation.

It is helpful always to remember that control persons, which likely includes many municipal advisor supervisors and owners, are subject to special liability provisions in the Securities Exchange Act of 1934. Section 20(a) of the Act contains the following regarding control persons:

*Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission in any action brought under paragraph (1) or (3) of section 21(d)), unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. [Emphasis added.]*

Without going into a detailed analysis of the control person provision, it is sufficient to state that the Courts have not required absolute control or actual participation in the primary violation.<sup>34</sup> Rather, the ability to influence the policies and actions of a party with primary

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<sup>33</sup> See, *e.g.*, MSRB Notice 2011-37, *Financial Advisors, Private Placements, and Bank Loans* (Aug. 3, 2011); MSRB Release, *MSRB Warns About Application of Federal Securities Laws to Private Placements in the Municipal Market; "Bank Loans" May Be Municipal Securities* (Aug. 3, 2011).

<sup>34</sup> See *Draney v. Wilson, Morton, Assaf & McElligott*, 597 F. Supp. 528, 530-531 (D. AZ 1983), stating:

The Ninth Circuit has interpreted this term "controlling person" to require proof of (1) a "power to influence" the controlled person ... .

liability often is sufficient. As often construed, the burden of proof on the issue of good faith and absence of inducement rests on the control person.<sup>35</sup>

Going forward, especially bearing in mind that complete dominance is not required to establish “control,” municipal advisor supervisors and other potential control persons need to be aware of their unique exposure and burdens posed by control person liability, which some may not anticipate.

The control provision does not depend on enforcement by the Commission, although the Commission is able to enforce it, but in addition the liability of control persons is available in private actions, when and if those may be brought.

In addition, with potentially broader application, Section 20(e) of the Securities Exchange Act provides, as follows:

PROSECUTION OF PERSONS WHO AID AND ABET VIOLATIONS—For purposes of any action brought by the Commission under paragraph (1) or (3) of section 21(d) [relating to enforcement action by the Commission], *any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.* [Emphasis added.]

Thus, secondary liability of municipal advisor personnel is not limited to control persons. Personnel who act intentionally or with recklessness, as defined by the Courts to aid and abet primary violations, are subject to secondary liability in enforcement actions brought by the Commission (but not in private actions).

Some municipal advisor personnel are unaware of the control person and aider and abettor liability provisions. The Board may wish to bring the provisions to the advisors’ attention. In any event, in providing guidance and assistance in Rules G-23 and G-42 to municipal advisor firms and their personnel, the Board may find it useful to keep these provisions in mind.

## **Conclusion**

In summary, it important to realize that MSRB Rule G-42 does not create the federal fiduciary duty of municipal advisors to municipal entities. The fiduciary duty is created in the Securities Exchange Act of 1934. Instead, Rule G-42 (and in a sense, Rule G-23) provides guidance on how financial/municipal advisors may comply with the statutory duty created in the Dodd-Frank Act and contained in the Securities Exchange Act of 1934. In many cases, municipal advisor responsibilities under federal and state law may extend beyond Rules G-23 and G-42.

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<sup>35</sup> See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9<sup>th</sup> Cir. 1990), stating:

According to the statutory language, once the plaintiff establishes that the defendant is a “controlling person,” then the defendant bears the burden of proof to show his good faith. [Footnotes omitted.]

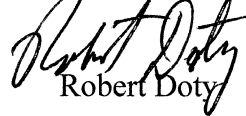
Some municipal advisors do not recognize the distinction between Rule G-42 and the statutory fiduciary duty, and may assume incorrectly that the entirety of their fiduciary duty is contained in Rules G-23 and G-42 and certain other Board rules, as opposed to the broad prophylactic of the fiduciary duty and antifraud provisions in the 1934 Act.

Rules G-23 and G-42 also do not create the fiduciary duty of financial/municipal advisors or of placement agents and remarketing agents under state law or certain other laws.

Nevertheless, the principles set forth in Rules G-23 and G-42 do provide important guidance with which municipal advisors should comply. In reviewing Rule G-23 and Rule G-42, I urge respectfully that the Board consider carefully a number of significant issues discussed in this letter. Those include discussing more explicitly the responsibilities of municipal advisors to warn issuers against transactional risks, the differentiation between the responsibilities of dealer and nondealer advisors as advisors, and municipal advisors' appropriate roles in selling bonds. I also urge consideration of the broad diversity of potential municipal advisor conflicts of interest, some of which have not been discussed generally.

Thank you again for this opportunity to submit comments regarding Rule G-23 and Rule G-42. In this letter, I have attempted to provide food for thought by the MSBR as it examines Rules G-23 and G-42. I hope that my comments are taken as a positive contribution as the Board discharges its responsibilities.

Yours very truly,



Robert Doty