sifma

Invested in America

April 11, 2011

Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1900 Duke Street
Alexandria, VA 22314

Re: MSRB Notice 2011-12 – Draft Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities (Feb. 14, 2011)

Dear Mr. Smith:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to comment on the Municipal Securities Rulemaking Board's ("**MSRB**") draft interpretive notice concerning the application of MSRB Rule G-17 to underwriters of municipal securities (the "**Proposal**").

I. Executive Summary

SIFMA supports the MSRB's desire to provide guidance to underwriters of municipal securities with respect to their "fair dealing" obligations. However, SIFMA believes that the MSRB should be careful not to transform the duty of fair dealing into a fiduciary-type obligation that imposes burdensome, expensive and unnecessary affirmative obligations by interpreting a prohibition on deception and fraud. Underwriters are not municipal advisors, and the standards applicable to each should be clearly distinguishable.

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

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In interpreting underwriters' duties, the MSRB should also avoid duplicating requirements to which underwriters currently are, or will soon become subject. For example, subjecting underwriters to disclosure obligations when recommending a derivative risks duplicating—or potentially conflicting—with the obligations underwriters will have under business conduct standards to be adopted by the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**"). Similarly, underwriters are already subject to various obligations under other regulatory regimes requiring them to have reasonable bases for representations they make, including potentially severe penalties for their failure to do so. Interpreting these obligations into the duty of fair dealing adds little additional protection to municipal entities, while creating additional uncertainty and risk to underwriters when their actions are reviewed in hindsight.

Further, the MSRB should reconsider imposing its judgment regarding necessary disclosures in the underwriting context. In most circumstances, municipal entity issuers understand and know how to make use of their bargaining power. Where a municipal entity believes disclosure of certain information would be useful, it can require that information to be disclosed as a condition in its request for proposals. Mandating disclosures that issuers do not want would simply add to the issuer's costs and creates paperwork burdens for underwriters, without providing any real benefits to municipal entities.

II. Relationship with Rule G-36

Under Rule G-17, an underwriter is required to "deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice." The Proposal purports to expound upon this duty of fair dealing that an underwriter owes to municipal entity issuers. In a separate proposal, the MSRB has sought comment on draft Rule G-36 and a draft interpretive notice relating to the fiduciary duties that a municipal advisor owes to its municipal entity clients.[2]

A. Rule G-17 Should Not Be Interpreted to Impose Fiduciary Obligations on Underwriters.

Section 975 ("**Section 975**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") distinguishes between municipal advisors, who are subject to a fiduciary duty when rendering advice to municipal entities under certain circumstances, and broker-dealers acting as

[2] *See* MSRB Notice 2011-14, Draft MSRB Rule G-36 (On Fiduciary Duty of Municipal Advisors) and Draft Interpretive Notice (Feb. 14, 2011).

underwriters, who are not subject to a fiduciary duty. Rather than recognizing these statutory distinctions, the Proposal, through interpretation, would apply elements of the fiduciary standard to ordinary underwriter activities. The Proposal goes beyond requiring underwriters to "deal fairly" and converts underwriters into a type of "fiduciary-lite," a heightened standard of duty far beyond the requirements of Section 975 and customary practice.

For example, under the Proposal, an underwriter that recommends a "complex" municipal securities financing that involves a derivative contract, an uncommon external index or other atypical arrangement that is integrally related to the financing must disclose all material risks and characteristics, as well as any incentives to recommend the transaction. Municipal entities that require an analysis of all material risks and characteristics of a transaction should either engage independent advisors, rather than relying upon underwriters, or contract specifically with underwriters to provide this service as part of their underwriting obligations. Moreover, underwriters, like other dealers in securities, should not be required to disclose all of their business relationships and methods of doing business, including their financial incentives, so long as they are not fraudulent or misleading.

B. Underwriters That Are Also Municipal Advisors.

SIFMA notes that the SEC has proposed, but not yet adopted, rules interpreting activities that would require registration as a municipal advisor.[3] Although what the final SEC rules will require is still unknown,[4] the Pending SEC

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[3] *See* Exchange Act Release No. 63576 (Dec. 20, 2010) (the "**Pending SEC Proposal**").

[4] Given this uncertainty, SIFMA generally believes the adoption of any MSRB interpretations in this area are premature and should be deferred until the SEC rules are finalized. *See* Comment Letter from Leslie M. Norwood, SIFMA, to Ronald W. Smith, MSRB (April 11, 2011) (our "**G-36/G17 Letter**") at 3–4.

As noted in our G-36/G17 Letter, it is critical that the MSRB consider in its various rulemakings and interpretations, the relationship and, therefore, proper sequencing of the various pending SEC and MSRB proposals and requests for comment. This is particularly evident in the case of the Proposal and the MSRB's proposed interpretive guidance on Rule G-23 (the "**G-23 Interpretation**") and its impact on underwriters of municipal securities offerings. The proposed G-23 Interpretation would prohibit a dealer that provided "advice" in respect of a securities issue from acting as an underwriter on that issue. *See* Proposed Rule Amendments and Interpretive Notice Filed Regarding Rule G-23 on Activities of Financial Advisors, MSRB Notice 2011-10 (Feb. 9, 2011). If the proposed G-23 Interpretation is adopted, prospective underwriters would be at risk of being precluded from acting as an underwriter if their initial discussions with an issuer is deemed to constitute "advice." Yet, the SEC and the MSRB are still evaluating the question of what is considered "advice" in the context of municipal advisors. In the meantime, interested (…continued)

Proposal could be interpreted to take a narrow view of the underwriter exception, such that the exception would only be available for actions within the core underwriter responsibilities.[5]

The MSRB should clarify how Rule G-17 will apply to underwriters of municipal securities in the event that the underwriter exception is ultimately interpreted very narrowly, and an underwriter is also deemed to be a municipal advisor for purposes of Rule G-36 with respect to its ancillary activities (such as recommending a swap that is integrally related to an underwriting). For example, when an underwriter performs both underwriting services and advises a municipal entity regarding a related swap, which activities will be governed by G-36 and which will be governed by G-17?

III. Underwriter Disclosure Requirements

A. Complex Municipal Securities Financings.

The Proposal would require that, where an underwriter of a negotiated issue recommends a financing that involves a (i) derivative (such as a swap), (ii) an atypical external index, (iii) unusual or variable issuer cash flows, or (iv) other atypical or complex arrangements integrally related to the financing, the financing would be considered "complex." Recommending a "complex" transaction would trigger additional disclosure obligations, such as "all material risks and characteristics" of the complex financing.

The MSRB should reconsider the types of transactions that it deems "complex." For example, municipal financings that have integrally related derivative components, such as an interest rate swap, are neither novel nor atypical. These types of transactions have become commonplace and are well understood by issuers. The municipal securities market has a history of transaction structures that were originally thought of as "complex" becoming extremely routine over the course of time.

Similarly, a transaction that may be "complex" to one issuer may not be "complex" to another issuer that enters into such transactions on a recurring basis. The MSRB should clarify that a transaction will only be deemed "complex"

(continued…)
parties are unable to assess or comment on the full impact on business practices and activities of the proposed G-23 Interpretation or the Proposal until the SEC and the MSRB resolve what activities and communications constitute "advice."

[5] *See* SEC Proposal 31–32.

where the municipal issuer informs the underwriter that the issuer has never engaged in the type of transaction before and therefore may not understand the transaction's material risks and characteristics. Requiring underwriters to provide detailed disclosures about commonly understood transactions will not provide additional protection for municipal entity issuers but will only serve to raise the cost of the offering to the issuer.

In any case, the MSRB should provide further guidance and definition with regard to what types of transactions will be considered "complex." References in the Proposal to "external index not typically used in the municipal securities market" and "atypical or complex arrangements" are vague and insufficient to give underwriters notice or certainty as to when the special disclosures will be required.

B. Requiring Disclosure Regarding Derivatives is Duplicative and May Be Inconsistent with Other Applicable Regulations.

As noted above, the Proposal would require underwriters that recommend "complex" financing transactions, such as those that include related swaps, to provide municipal entity issuers with disclosure regarding the material risks and characteristics of the swap.

In light of ongoing rulemakings by the CFTC and the SEC, the MSRB should defer the imposition of any disclosure requirements or other business conduct standards relating to swaps and security-based swaps, as these will be the subject of detailed requirements to be established by the CFTC and the SEC and were already provided for by Congress in Title VII of the Dodd-Frank Act.[6] If adopted, the Proposal would layer additional requirements on swap dealers and security-based swap dealers that could create multiple, duplicative and potentially conflicting obligations. Even in a circumstance where the underwriter is not, itself, a swap dealer or a security-based swap dealer, and is merely recommending and arranging a swap with a third party, it will be subject to CFTC- and SEC-established duties applicable to introducing brokers, futures commission merchants and broker-dealers.

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[6] *See* Commodity Exchange Act § 4s(h)(3) (adopted under Section 731 of the Dodd-Frank Act) ("Business conduct requirements adopted by the [CFTC] shall … require disclosure by the swap dealer or major swap participant … information about the material risks and characteristics of the swap…."); Securities Exchange Act § 15F(h)(3) (adopted under Section 764 of the Dodd-Frank Act); *see also* CFTC Proposed Rule, Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80638 (Dec. 22, 2010).

C. Credit Default Swaps.

The Proposal would require that if an underwriter, in its dealer capacity, issues or purchases credit default swaps ("**CDS**") that reference the obligations of the municipal entity issuer, the underwriter must disclose those activities to the issuer.

The MSRB should reconsider this disclosure requirement because it is highly prejudicial to require underwriters to disclose their hedging and risk management activities. Such disclosure may hinder such risk management and potentially compromise counterparty relationships. Moreover, even without the Proposal, if a municipal entity issuer believes this type of disclosure is useful, the municipal entity issuer can request it, and prospective underwriters can determine whether they are willing to provide such information.[7] We note that, while the Proposal states that "trading in such municipal credit default swaps … has the potential to affect the pricing of the reference obligations," an analysis by the California State Treasurer of trading by six major underwriters in CDS that referenced California general obligation bonds found that "CDS trading's [*sic*] effect on bond prices is not significant enough to cause concern at this time."[8]

If the MSRB retains this requirement, it should exempt dealing in CDS that reference a basket of securities that include the issuer's securities, among others. The conflict of interest concerns asserted in the Proposal are not applicable to CDS on a basket, which would have less impact—if any at all—on the pricing of each issuer's securities.

Finally, the MSRB should confirm that generalized disclosures for CDS activities are sufficient. Underwriters that are part of large financial institutions may not be aware of all the activities of other separate desks within the firm. Even if an underwriter is able to confirm in advance of an offering that the underwriter is not dealing in CDS of the issuer, it cannot know in advance whether it will do so in the future. The MSRB should therefore confirm that general disclosures are satisfactory so long as they put the issuer on notice of the possibility that the underwriter may, from time to time, engage in such dealing, rather than that the underwriter, in fact, is engaging in the activity.

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[7] We understand that a very small number of municipal issuers have, in fact, chosen to require this information be disclosed.

[8] *See* News Release, California State Treasurer Bill Lockyer, *Treasurer Lockyer Releases Data on Major Banks' Trading of Derivatives Linked to California Bonds* (Apr. 22, 2010), *available at* http://www.treasurer.ca.gov/news/releases/2010/20100422.pdf.

D. Payments To or From Third Parties.

The Proposal would interpret an underwriter's duty of fair dealing to require it to disclose to the municipal entity issuer any payments received by the underwriter from third parties in connection with the underwriting, and any payments made by the underwriter to third parties in connection with the underwriting, as well as the details of any "third-party arrangements for the marketing of the issuer's securities."

The MSRB should confirm that an underwriter need only *disclose* to an issuer payments to or from third parties in connection with an underwriting, but need not receive any form of consent from the issuer. The MSRB should also clarify the extent of the "details" regarding any third-party arrangements for the marketing of the issuer's securities that the underwriter must disclose to the issuer. SIFMA notes that third-party arrangements are typically already disclosed in the official statement.

Additionally, the MSRB should confirm that the term "third parties," for this purpose, refers to parties other than (i) the municipal entity issuer, and (ii) the underwriter and its affiliates. As such, internal payments or other internal credits among the underwriter and its affiliates would not be deemed to be a "third-party payment" and need not be disclosed. SIFMA believes that such internal arrangements do not raise the same risks of coloring a party's judgment that are concerns where payments are made between true third parties.

An underwriter should not be required to disclose to the issuer payments or other benefits received or given in relation to collateral transactions, such as credit default swaps, except where failure to do so would be fraudulent or constitute a misrepresentation. As noted above, an underwriter should be entitled to manage its risks without such disclosures. In addition, the proposed standard is highly inconsistent with the obligations of ordinary underwriters for non-municipal issuers under existing rules of the SEC and the Financial Industry Regulatory Authority.

E. Official Receiving Disclosures.

The Proposal would require an underwriter to make the required disclosures to an official of the municipal entity issuer who has the authority to bind a municipal entity.

The MSRB should clarify what level of diligence an underwriter would be required to undertake in order to determine whether the official receiving the disclosures has "authority to bind the issuer by contract with the underwriter." In

practice, underwriters may deal with officials of the issuer who do not have the authority to bind the issuer in relation to the issuance of securities, but who are nonetheless sufficiently senior in stature to be capable of understanding and taking action, if necessary, in relation to such disclosure.

An underwriter should not be viewed as having breached its duty of fair dealing simply because it erred in its understanding of the signing authority of a municipal entity issuer's official. Instead, SIFMA suggests that an underwriter's reasonable belief that the official has such authority should satisfy its duty. A representation to this effect by the receiving official should be a sufficient basis for the underwriter to form this reasonable belief, absent the underwriter's actual knowledge that such representation is false.

F. Disclosures Need Not Be Repeated.

The MSRB should confirm that, with respect to any information that would be required to be disclosed under the Proposal, an underwriter need not re-disclose such information if the information was contained in the underwriter's response to a municipal entity issuer's request for proposals or otherwise provided to the issuer before the underwriter was formally engaged.

IV. Underwriter "Reasonable Basis" Diligence Obligations

A. Provision of a Certificate.

Under the Proposal, an underwriter would be required to have a "reasonable basis" for providing representations and material information in a certificate that will be relied upon by the municipal entity issuer or other relevant parties to an underwriting (*e.g.*, an issue price certificate).

The MSRB should reconsider this interpretation. An underwriter's basis for its provision of an issue price certificate is not a matter properly considered to be within an underwriter's duty of fair dealing to a municipal entity issuer. In any case, existing laws assure that underwriters do not provide issue price certificates without a reasonable basis, and sufficient penalties already exist if an underwriter were to do so. For example, an underwriter could be subject to substantial penalties under Section 6700 of the Internal Revenue Code if, in connection with facilitation of a municipal bond offering, it makes a statement that will be relied on for determining the tax-exempt status of the bonds that it knew or should have

known was false.[9] Underwriters could also potentially be liable for misstatements under wire fraud statutes or under state laws. Because this is an area already well regulated under other regulatory schemes and by other regulators, it does not need additional regulation by the MSRB, and the MSRB should revise the Proposal to remove this obligation.

If the MSRB determines to maintain this interpretation, it should clarify how it believes an underwriter must determine that it has a reasonable basis for providing representations and material information in a certificate. Specifically, the MSRB should confirm that an underwriter would meet its "reasonable basis" obligation where it verifies the information in the certificate against the official books of the underwriter and any other factual information within the underwriter's control.

B. Underwriter's Obligations with Respect to Official Statements.

The Proposal would require, as part of an underwriter's duty of fair dealing to municipal entity issuers, that the underwriter have "a reasonable basis for the representations it makes, and other material information it provides … in connection with the preparation by the issuer of its disclosure documents." SIFMA believes that this requirement is unreasonably broad and open-ended.

As is current practice, the MSRB should permit an underwriter to agree with an issuer that the underwriter will only be responsible for materials furnished to an issuer if the underwriter has (i) consented, in writing, to such materials being used in offering documents and (ii) agreed with the issuer that the underwriter and not the issuer will assume responsibility for the accuracy and proper presentation of such material. Otherwise, an underwriter would be reluctant to provide financial analysis that may be useful to the issuer (such as providing cash flows based upon various hypothetical assumptions) even if the underwriter has not assumed responsibility for (and the issuer has not assumed the cost of) detailed verification by the underwriter of the assumptions or facts.

The MSRB should also clarify that an underwriter may limit its responsibility for information provided by disclosing to the issuer any limitations on the scope of its analysis and factual verification it performed. In addition, any

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[9] *See*, *e.g.*, Office of Chief Counsel, Internal Revenue Service, Memorandum No. 200610018, *Application of Section 6700 Penalty with Respect to Various Participants in Tax-Exempt Bond Issuance* (Feb. 3, 2006), *available at* http://www.irs.gov/pub/irs-wd/0610018.pdf.

duty should extend only to *material* information provided by the underwriter and not to all information and analysis.

C. Fair Pricing.

The Proposal would interpret an underwriter's duty of fair dealing to include an "implied representation" that the price the underwriter paid to an issuer "bears a reasonable relationship to the prevailing market price of the securities."

The MSRB should not interpret as part of an underwriter's duty of fair dealing an "implied representation" that the price an underwriter pays to an issuer bears a reasonable relationship to the prevailing market price of the securities. In a negotiated underwriting, the underwriter should only be required to purchase securities at the price it and the municipal entity issuer negotiated and agreed upon in good faith. Moreover, in many cases underwriters already provide a representation as to the fair market price in its tax certificate, an additional implied representation regarding the "prevailing market price" is unnecessary.

The MSRB's proposed "prevailing market price" standard is also entirely subjective and subject to hindsight bias. In the case of new issue securities, particularly where there is no existing market for the securities being underwritten, there is no "prevailing market" for the securities so there is no way for an underwriter to assure that it can comply with this obligation. The standard would impose a paralyzing evidentiary burden on an underwriter by requiring is to show that an issue price had a "reasonable relationship" to an as-of-yet non-existent prevailing market price. This would require an underwriter to foresee the future, or be forced to negotiate against itself to be sure it is not later questioned for having underpriced the securities.

Further, because municipal issuers have unique credit and risk characteristics, this standard would effectively reinforce the use of credit ratings as a proxy for credit analysis in determining the comparability of different securities issues, which is contrary to the direction of the Dodd-Frank Act and SEC policy guidance.[10]

D. Profit-Sharing Arrangements.

The Proposal would interpret, as a violation of an underwriter's duty of fair dealing, an arrangement under which an underwriter shares in an investor's

[10] *See, e.g.*, Dodd-Frank Act § 931 (Congressional findings).

profits earned on the resale of the securities, "depending on the facts and circumstances."

The MSRB should provide further guidance as to when profit-sharing with investors would, "depending on the facts and circumstances," constitute a violation of MSRB Rule G-17. The interpretive notice provides almost no guidance as to examples of the type of behavior the MSRB is intending to address with this prohibition, or what "facts and circumstances" would result in a violation.

E. Retail Order Period Compliance.

The Proposal would interpret an underwriter's duty of fair dealing to include an obligation to honor any agreement with an issuer as to retail order period directions, unless it receives the issuer's consent to deviate from the issuer's requirements. Particularly, the Proposal would require an underwriter "to take reasonable measures to ensure that retail clients are *bona fide*."

The MSRB should clarify that a dealer's obligations with respect to retail order periods and *bona fide* retail customers will be measured by at least a reasonableness test, and that a dealer will not be strictly liable for violating the issuer's retail order periods unless, under the facts and circumstances, it should have known that the order did not qualify as a "retail order." To this end, the MSRB should confirm that a representation from co-managers in the Agreement Among Underwriters to the effect that retail orders of co-managers are *bona fide* should sufficiently demonstrate that the senior manager took reasonable measures to verify *bona fide* retail orders for syndicate offerings.

F. Dealer Payments to Issuer Personnel.

The Proposal "reminds" dealers of their obligations under Rule G-20 with respect to gifts, gratuities and other payments to personnel of an issuer.

The MSRB should confirm that the Proposal does not imply any new obligations or introduce any new interpretations of a dealer's existing obligations under Rule G-20 and serves only as a "reminder." If this is not the case, the MSRB should instead include any guidance it proposes concerning business entertainment, gifts and pay-to-play rules in a substantive proposal or interpretation under Rule G-20, rather than as vague references in the Proposal.

V. Implementation Period.

The Proposal would obligate underwriters to comply with detailed and specific requirements to which they are not currently subject. Many of these requirements, depending on whether they are adopted as proposed, will require significant lead time in order for underwriters to create systems to ensure compliance. Therefore, SIFMA requests that when final guidance regarding the application of Rule G-17 to underwriters is adopted, the MSRB provides for a reasonable implementation period, which would certainly be no less than one year, before the Proposal becomes effective.

VI. Conclusion

SIFMA supports the MSRB in its efforts to provide guidance to underwriters regarding their duties to municipal entity issuers. However, as discussed above, the Proposal should be revised to make clearer distinctions between the fiduciary duties owed by municipal advisors and the more limited duty to deal fairly owed by underwriters. In interpreting this duty, the MSRB should do so in a way that does not duplicate or impose conflicting obligations on underwriters, or create burdens on underwriters that issuers neither want nor benefit from.

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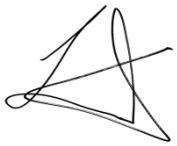
SIFMA appreciates this opportunity to comment upon the MSRB Draft Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities. Please do not hesitate to contact me with any questions at (212) 313-1130; or Robert L.D. Colby and Lanny A. Schwartz, of Davis Polk & Wardwell LLP, at (202) 962-7121 and (212) 450-4174, respectively.

Sincerely yours,



Leslie M. Norwood
Managing Director and
Associate General Counsel

cc: ***Securities and Exchange Commission***
The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
Robert Cook, Director, Division of Trading and Markets
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