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June 4, 2004

Ernesto A. Lanza, Esq.
Senior Associate General Counsel
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, Virginia 22314

RE: Comments to Proposed Rule G-38 Amendments

Dear Mr. Lanza:

The Bond Market Association¹ ("Association") appreciates this opportunity to respond to the notice ("Notice") issued by the Municipal Securities Rulemaking Board ("MSRB") on April 5, 2004, in which the MSRB proposes draft amendments to Rule G-38.² In particular, the Association agrees with the MSRB that Rule G-38's disclosure requirements have been extremely effective in identifying broker-dealer practices regarding the use of Consultants, as defined under that Rule. However, the Association strongly disagrees with the MSRB's assertion that the disclosures made pursuant to these requirements raise concerns of Consultants circumventing Rule G-37's prohibition on political contributions or otherwise engaging in aggressive or abusive practices. This letter describes the valuable role of Consultants in the municipal securities industry and why there is no reason for concern regarding their practices. Moreover, the Association proposes an alternative Rule amendment that would eliminate even the appearance of pay-to-play by prohibiting Consultant contributions that are currently reportable under Rule G-38.

The Association understands that the MSRB's purpose in issuing the Notice is primarily to seek comments and information, and not to arrive at any conclusion or judgment, regarding the practices of Consultants in the municipal securities industry. However, the public may mistakenly view the concerns expressed by the MSRB in the Notice as such conclusions or judgments, especially given that the Notice was issued as a proposed regulatory amendment rather than a mere request for comments

¹ The Association represents securities firms and banks that underwrite, distribute and trade fixed income securities and other credit market instruments in the U.S. and globally. Additional information about the Association and its members and activities is located at www.bondmarkets.com.

² MSRB Notice 2004-11.



and received significant negative press attention pre-judging the role of Consultants. Thus, the Association submits these comments in an effort to avoid those possible inferences and to provide recommendations to ensure the integrity of the municipal securities industry, while accurately reflecting Consultant practices in the industry.³ Indeed, the Association's long history and extensive activity in developing best practices, market guidelines and trading standards for the municipal and other fixed income markets, illustrates our commitment to maintaining and enhancing the highest levels of professionalism and integrity in our markets.

Consultants serve a legitimate and important role in the industry by permitting broker-dealers that do not have the resources to maintain an office or an adequate presence in a particular jurisdiction to compete for municipal securities business in that jurisdiction. This permits issuers to have more choices and increases competition, which in turn lead to the issuer and the investing public receiving better service at lower rates. Given their local presence, Consultants also have unique knowledge regarding the local issuer's needs and requirements, thus permitting the broker-dealer to more effectively provide services to that issuer. In many cases, Consultants are hired to perform necessary services, such as providing technical/educational support or strategic advice to the broker-dealer. A broker-dealer may even outsource certain functions related to a municipal securities deal to a Consultant (e.g., recordkeeping function).⁴ Thus, rather than harming the integrity of the market, Consultants help preserve the interests of the investing and taxpaying public.

There is no evidence to warrant the MSRB's concerns that Consultants are being used indirectly to make prohibited political contributions under Rule G-37 or that Consultants may be using more aggressive tactics in contacting issuers. The MSRB bases these concerns on its general statements that there has been an increase in reported Consultant contributions and in the compensation paid to Consultants.

These grounds for concern, however, do not indicate or imply any improper behavior by Consultants. For example, the MSRB states that there has been a "significant increase" in the political contributions made by Consultants. However, the incidence of broker-dealers hiring Consultants who make political contributions has increased only minimally. Indeed, the percentage of Consultants who made reportable political contributions to issuer officials only increased by slightly over 2% (from 11.3% to

³ Please note that although not addressed in Question & Answer ("Q&A") form, many of the questions posed by the MSRB in the Notice are addressed in these comments.

⁴ The MSRB recognized this outsourcing possibility in Rule G-38 Q&A (March 4, 1999).



13.8%) during the last four-year period, between 2000 and 2003.⁵ In other words, in 2003, over 86% of the Consultants in the industry did not make any reportable contribution to an issuer official. This strongly supports the conclusion that Consultants are being used for the legitimate services and advice they provide (e.g., by having a local presence and knowledge of local issuers) rather than for their political contributions. More importantly, regardless of the level of the contributions being made, there is no indication whatsoever that Consultant contributions are being used to influence decisions regarding municipal securities business.

The MSRB is also concerned because there has been an increase in the compensation paid to Consultants. This increase, however, does not in any way indicate or imply that Consultants are engaging in pay-to-play or that there is added pressure on Consultants to engage in aggressive or abusive practices. Rather, the recent increase in compensation appears to be attributable to the significant increase in the volume and size of municipal securities deals. As described in footnote 5, the total amount of new issuance of municipal securities went up 87% -- from \$241.8 billion in 2000 to \$452.4 billion in 2003.⁶ Moreover, the average size of a municipal securities offering went up 55% -- from \$15.9 million in 2000 to \$24.6 million in 2003.⁷ Compensation paid to broker-dealer employees in the municipal securities industry has also increased due to this increase in the volume and size of the issuances. Please note that even if there were no explanation for the increased compensation, there is no evidence of a correlation between increased compensation and aggressive or abusive practices. In fact, there may actually be an increased incentive on the part of the Consultant not to jeopardize such a lucrative practice by engaging in improper activity.

⁵ Between 2000 and 2003, the total number of Consultants increased from 582 to 954. The number of Consultants who made reportable contributions to issuer officials increased from 66 (11.3%) to 132 (13.8%). Please note that the increase in the total number of Consultants is likely due to the increase in municipal securities issuances. In 2003, a total of \$452.4 billion in municipal securities was issued compared to \$241.8 billion in 2000, an increase of 87%. See Thomson Financial Securities Data. The number of municipal securities transactions also increased from 15,216 in 2000 to 18,390 in 2003.

⁶ See id. In contrast, the total amount of municipal securities issuances decreased by 10% between 1997 (when a total of \$267.1 billion was issued) and 2000 (when a total of \$241.8 billion was issued). See id.

⁷ See id. In contrast, the average size of municipal securities deals decreased by 1% between 1997 (when the average size was \$16.1 million) and 2000 (when the average size was \$15.9 million). See id.



In light of the legitimate and important role of Consultants, the Association addresses below the specific amendments proposed by the MSRB.

I. Non-Associated Persons Should Continue to Be Permitted to Act as Consultants

The draft amendment prohibits a broker-dealer from paying any person for soliciting municipal securities business, unless that person qualifies as an "associated person," as defined under the Securities Exchange Act of 1934 ("34 Act"). As discussed above, there is no indication that the alleged abuses, which this amendment is supposed to address, actually exist. The following describes other problems with this amendment and then proposes an alternative restriction on Consultants, which would eliminate even the appearance of pay-to-play. Please note, however, that if the MSRB does ultimately require all solicitors to be associated persons under the '34 Act, either the MSRB or the Securities and Exchange Commission ("SEC") must provide clear guidance as to what is required for an independent contractor to qualify as an associated person and the level of supervision to be provided by the broker-dealer. Current MSRB and SEC guidance is lacking on this subject.

Without such guidance, broker-dealers would be subject to arbitrary and capricious enforcement when it comes to using independent contractors to solicit municipal securities business. With such risk, broker-dealers would be forced to discontinue the use of independent contractors for the purpose of soliciting municipal securities business.

A. Rule G-38 Works in Its Current Form

Rule G-38 works well in its current form in that it requires full disclosure, not only to the MSRB but also to the issuers and the general public, regarding the Consultant's compensation, role, and political contributions. Such extensive disclosure (which would be lost under the draft amendment) minimizes, if not eliminates, the possibility of abusive practices. Indeed, there already is a regulatory mechanism in place that prohibits Consultants from engaging in pay-to-play. Rule G-37 prohibits broker-dealers from indirectly making prohibited contributions using their Consultants and imposes a two-year ban on municipal business on the broker-dealer if a violation occurs. Pay-to-play practices of Consultants, if any, should be eliminated by enforcing this prohibition based on the totality of the circumstances in a given case, rather than indiscriminately eliminating the use of Consultants altogether. The transparency created under current Rule G-38 disclosure requirements should facilitate such enforcement.



B. The Associated Person Concept is Impractical and Unworkable

As discussed above, broker-dealers that do not have the resources to maintain an office or an adequate presence in a particular jurisdiction use Consultants as an affordable way to compete for municipal securities business in that jurisdiction.⁸ By requiring Consultants to become associated persons, geographical restraints may make it impossible for a broker-dealer to supervise a Consultant as an associated person unless the broker-dealer maintains such adequate presence in that jurisdiction. The proposed amendment would also make it unfeasible for broker-dealers with limited resources to retain Consultants who provide certain necessary services, such as technical/educational support (i.e., experts who can educate the issuer and the broker-dealer in a particular area). This includes the ability of broker-dealers to outsource certain functions related to a municipal securities deal. Moreover, given that only individuals may be considered to be associated persons, the proposed amendment would eliminate a broker-dealer's ability to use consulting firms.

Additional burdens are imposed on associated persons under MSRB Rules and the '34 Act, including, but not limited to, the requirement that associated persons become subject to the broker-dealer's insider trading policy; that they be trained and possibly registered by passing a qualifying exam; and that they refrain from meeting with members of the public for at least ninety (90) days following such qualification.⁹ There are further restrictions on associated persons under National Association of Securities Dealers and New York Stock Exchange rules that may be applicable. These burdens are further compounded by the fact that there is no clear guidance as to what is required to make an independent contractor an associated person.

Thus, the cost of treating Consultants as associated persons would unfairly drive many of these capable broker-dealers (including many women and minority-owned firms) out of the municipal securities business industry, especially given that the margins of profit in the industry are relatively low. Moreover, even if a broker-dealer is large enough not to be driven out of the business, it would still be required

⁸ It is interesting to note that J.P. Morgan Chase, which submitted a comment letter supporting the MSRB's proposed amendment, confirmed this by stating in a newspaper article that J.P. Morgan Chase no longer needs to hire independent Consultants, given its pending merger with Bank One will enable it to have an increased local presence around the country. *J.P. Morgan Backs Ban on Consultants*, The Bond Buyer (April 30, 2004).

⁹ Sections 15(f) and 15(b)(7) of the '34 Act; MSRB Rule G-3.



to incur these significant additional costs for apparently no reason, given that there is no evidence of Consultants engaging in abusive practices.

C. The MSRB's Draft Amendment Is Unconstitutional

Requiring Consultants to essentially become Municipal Finance Professionals ("MFPs") under Rule G-37 would violate the First Amendment of the Constitution. In particular, the Supreme Court has equated political contributions with speech that is protected under the First Amendment.¹⁰ Thus, to restrict political contributions, a rule must be narrowly tailored to advance a compelling governmental interest. For example, the D.C. Circuit Court in Blount v. SEC upheld Rule G-37 because the Rule was narrowly tailored to address the government's compelling interest of eliminating pay-to-play in the municipal securities industry.¹¹ To satisfy the "narrowly tailored" test, the government must demonstrate (1) that "the ills it claims the rule addresses in fact exist and the rule will materially reduce them," and (2) that the Rule is necessary where there is no "less restrictive alternatives to the rule [that] would accomplish the government's goals equally or almost equally effectively."¹²

If Consultants are required to become MFPs, thus expanding Rule G-37's ban on political contributions to those Consultants, Rule G-37 would no longer satisfy this narrowly tailored test. There is no evidence that Consultants are being used by broker-dealers to engage in pay-to-play. Even if the problem of Consultants engaging in pay-to-play were to exist, the draft amendment's restrictions far exceed what would be necessary to address that problem. As described above, by coupling the indirect violation provision of Rule G-37 with the extensive disclosure requirements of Rule G-38, the government is already in the position to effectively deal with Consultant pay-to-play practices that may exist in the industry, if any. In fact, in defending Rule G-37 before the Blount Court, the Securities Exchange Commission ("SEC") explained:

that the "loopholes" that remain [in Rule G-37] are due to its "sensitivity" to First Amendment concerns; [the SEC] believes that closing the supposed loopholes would broaden the regulation's scope beyond that "necessary" to accomplish its interests.¹³

¹⁰ See Buckley v. Valeo, 424 U.S. 1, 96 S.Ct. 612 (1976).

¹¹ 61 F.3d 938 (D.C. Cir. 1995).

¹² Id. at 944.

¹³ Id. at 946-947.



When the Blount case was being decided, one of these supposed “loopholes” was that Consultants were not subject to Rule G-37. Thus, even the SEC has confirmed that expanding Rule G-37 as proposed in the draft amendment would result in an excessive infringement of the First Amendment right to free speech.

D. Alternative Restrictions for Consultants

While there is no need to amend Rule G-38, to the extent the MSRB feels more is needed to avoid even the appearance of pay-to-play, the Association recommends taking a more tailored approach by imposing the following restrictions on Consultants, rather than eliminating Consultants altogether.

Under this approach, broker-dealers would still be permitted to retain non-associated persons as Consultants. However, Consultants would be prohibited from making political contributions that are currently reportable under Rule G-38. In particular, broker-dealers would be required to include in their Consultant agreements a provision that at the very least prohibits the Consultant from making a contribution to an official of an issuer during the six (6) month period preceding, or six (6) month period following, the Consultant’s solicitation of municipal securities business from that issuer.¹⁴ Moreover, broker-dealers would be prohibited from hiring a Consultant to solicit an issuer, if that Consultant has contributed to an official of that issuer during the preceding six (6) month period. If the MSRB decides to adopt this alternative proposal, Consultants who have already been retained by a broker-dealer at the time the alternative proposal takes effect should not be subject to this six (6) month look-back prohibition. This is necessary to allow for a fair and smooth transition for those Consultants who may have made a perfectly appropriate contribution under current Rule G-38.

To enforce the above contractual provision, broker-dealers could be required to automatically terminate their Consultant agreements and cease paying Consultants upon learning of a prohibited contribution. Broker-dealers may also be required to obtain periodic (*e.g.*, quarterly) certifications from their Consultants confirming that the Consultants have not made a prohibited contribution or listing all of the political contributions made by the Consultants during that quarter.

This approach is much more reasonable than the MSRB’s proposal of eliminating Consultants in that the restrictions are proportional to the paucity, or complete lack, of evidence regarding Consultants and pay-to-play. Moreover, the restriction is tailored to political contributions and pay-to-play and does not arbitrarily eliminate

¹⁴ As is the case under current Rule G-37 and Rule G-38, there would be an exemption for individuals who contribute no more than \$250 per election to a candidate for whom he or she is entitled to vote.



an important segment of the municipal securities industry. Indeed, by requiring broker-dealers to report the above Consultant contributions under the current Rule G-38, the MSRB made a determination that those contributions are the only ones that can raise the issue of pay-to-play. Under our proposed alternative, these contributions will simply be prohibited, thereby removing any doubt or question regarding pay-to-play. The tailoring of the restriction in this manner also increases the likelihood of the rule amendment surviving scrutiny under the Constitution. Please note that even this more tailored approach will cause certain qualified Consultants to simply get out of the industry given that it would prohibit them from making contributions in connection with their other lines of business, such as their legislative lobbying services on behalf of other industries.

II. The MSRB Should Modify its Definition of Solicitation

The MSRB proposes to define the act of “soliciting” municipal securities business (for purposes of triggering MFP status under Rule G-37 as well as the proposed Rule G-38 amendment prohibiting non-associated persons from soliciting such business) as any direct or indirect communication with an issuer for the purpose of obtaining or retaining municipal securities business. However, there are certain implications of this proposal that concern the Association.

A. Solicitor MFPs under Rule G-37 Should Not Include Those Who Merely Communicate with Third Parties

In the process of describing the above proposal, the MSRB states that whether an employee becomes a solicitor MFP under current Rule G-37 is not dependent upon the person who is solicited. Thus, the MSRB apparently believes that an employee becomes a solicitor MFP under Rule G-37 merely by soliciting municipal securities business from a private obligor in a conduit deal, regardless of whether that obligor is being used to ultimately solicit the issuer. This position, however, is contrary to the purpose underlying Rule G-37 as well as the formal interpretations previously issued by the MSRB.

Although the current plain language of Rule G-37 is unclear on this issue, it does not require that the term “solicitation” be read to include mere discussions with private obligors. To the contrary, each interpretation that the MSRB issued as to what constitutes a “solicitation” under Rule G-37 specifically states that the solicitation activity in question must be aimed at the issuer. For example, the MSRB interpreted the term solicitation to include any “activities calculated to appeal to issuer officials for municipal securities business, or which effectively do so.”¹⁵ The MSRB also gave as examples of solicitation the making of presentations to “issuer officials”

¹⁵ MSRB, Q&A #2 (December 7, 1994) (emphasis added).



regarding municipal securities business, or merely attending a meeting where such presentation occurs.¹⁶

Limiting the term “solicitation” to such issuer-targeted activity is consistent with the purposes of Rule G-37. In particular, the goal of Rule G-37 is to eliminate “pay-to-play,” whereby broker-dealers use political contributions to influence the underwriter selection process. Thus, to treat an individual as an MFP, there should at least be some possibility of his or her contribution influencing this process. However, in a conduit deal, if an employee is only communicating with a private obligor and not the issuer, there is no possibility that a contribution made by that employee to an official of that issuer would influence the underwriter selection process. The issuer would not even know that the employee is involved given that the employee is only dealing with the private obligor. Moreover, contributions made to an issuer official have no potential of influencing any decision made by the private obligor given that the employees and officers of the private obligor do not have an interest in the outcome of elections. In most cases, when an employee approaches a private obligor regarding a conduit deal, they do not even know which issuer will be used for the bonds.

The linkage between the contribution and the underwriter selection process is also required under the Constitution. In particular, to satisfy the “narrowly tailored” test, a regulation must be closely drawn (i.e., pay-to-play) and may not restrict activity beyond that which is necessary to address the concern in question.¹⁷ Triggering Rule G-37’s prohibition on contributions due to an employee’s relationship with a private obligor, where there is no linkage between a contribution and the selection process, would go well beyond that which is necessary to prevent pay-to-play. Indeed, the Court upheld Rule G-37 on the basis that the Rule:

constrains relations only between the two potential parties to a quid pro quo: the underwriters and their municipal finance employees on the one hand, and officials who might influence the award of negotiated municipal bond underwriting contracts on the other.¹⁸

Moreover, if the MSRB were to conclude that communications with private obligors result in a “solicitation,” the results would be troubling. In particular, unless the MSRB limits the term “solicitation” to activity aimed at an issuer, an employee would be in jeopardy of qualifying as an MFP any time he or she communicates with

¹⁶ Id.; MSRB, Q&A #1 (March 22, 1995).

¹⁷ See Blount, 61 F.3d at 947.

¹⁸ Id. (emphasis added).



any private entity or person, such as a lawyer or a project team member (e.g., an investment advisor firm) regarding a municipal issuance. Such result would, by any measure, be outside of the intent of Rule G-37.

The MSRB recognized this when it drafted Rule G-38 by making clear that to qualify as a Consultant, one must communicate directly or indirectly with an issuer. This sheds light on what is meant by "solicitation" under Rule G-37 given that the purposes of Rules G-37 and G-38 are the same – to eliminate the corrupt influence of political contributions on the underwriter selection process. Indeed, Rule G-38 was drafted to address possible indirect violations of Rule G-37 where broker-dealers use Consultants to make otherwise prohibited contributions to issuer officials.¹⁹ Thus, in applying the term "solicitation" in the Rule G-37 context, there is no reason to take an approach that is different from that set forth in Rule G-38.

Based on the above, we request that the MSRB adopt the proposed definition of "solicitation" for purposes of Rule G-37. By doing so, the MSRB would make clear that an employee becomes an MFP only by directly communicating with an issuer or indirectly communicating with an issuer through a third party, such as a private obligor. The MSRB may also issue an interpretation making this clarification without formally amending Rule G-37. We also agree with the MSRB that even if one is communicating with an issuer, it should be done with the intent of obtaining municipal securities business for it to qualify as a solicitation.

Alternatively, if the MSRB continues to interpret Rule G-37 to cover mere communications with private obligors, it should carve out an exemption that reflects how conduit deals really work. In particular, the MSRB claims that Rule G-37 currently exempts from the definition of "solicitation" a situation where an employee (as part of his investment banking services) merely advises a private obligor on appropriate financing alternatives, including conduit issuances, and provides to the obligor contact information of the municipal finance employee who can assist in the underwriting. This exemption should be expanded to also permit the employee to internally refer the matter to the municipal finance employee. Thus, the employee would be permitted not only to give the obligor the municipal finance employee's contact information but also to talk to the municipal finance employee and ask him or her to call the obligor. This more accurately reflects how investment banking advisors actually operate as they provide the panoply of financing options to their client.

¹⁹ See MSRB Reports, Vol. 14, No. 3 (Jun. 1994); Notice of Filing of Proposed Rule Change by the MSRB Relating to Consultants, File No. SR-MSRB-95-15 (Nov. 28, 1995).



**B. Those Providing Professional Services to a Broker-Dealer
Should Be Expressly Exempted**

In an effort to consolidate the definition of solicitation for purposes of Rule G-37 and Rule G-38, the MSRB eliminates the language of current Rule G-38 that expressly exempts from the definition of Consultant professionals who merely provide legal, accounting, engineering, and legislative lobbying services ("Professionals").²⁰ At the same time, the MSRB states that the existence of an "intent" to obtain municipal securities business is important in determining whether a solicitation has occurred. Based on this reasoning, Professionals appear to still be exempt from the definition of solicitation in that their purpose is not to obtain municipal securities business but solely to provide Professional services to the broker-dealer. Moreover, the policy consideration has not changed that these outside Professionals provide a valuable service to broker-dealers.

However, by eliminating Rule G-38's language regarding Professionals, the MSRB creates doubt as to whether Professionals are exempt. Thus, we request that the MSRB confirm either in the Rule's definition of solicitation or through an interpretation that Professionals would not be deemed to be soliciting municipal securities business under Rule G-38.

We look forward to discussing these issues further with the MSRB staff, and appreciate your attention to our comments. Please contact the undersigned at (646)637-9218 or via e-mail at Lhotchkiss@bondmarkets.com with any questions that you might have.

Sincerely,

A handwritten signature in cursive script that reads "Lynnette Kelly Hotchkiss".

Lynnette Kelly Hotchkiss
Senior Vice President and
Associate General Counsel

²⁰ The exemption for legislative lobbyist is not found in the language of Rule G-38 but in MSRB Q&A #5 (February 28, 1996).



cc: ***Securities and Exchange Commission***

The Honorable William H. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
Giovanni P. Prezioso, General Counsel, Office of the General Counsel
Annette L. Nazareth, Director, Division of Market Regulation
Martha Mahan Haines, Director, Office of Municipal Securities

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The Bond Market Association

Executive Committee, Municipal Securities Division
Legal Advisory Committee, Municipal Securities Division
Policy Committee, Municipal Securities Division
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