

SEC Approves New Municipal Advisor Fiduciary Duty Rule

The new MSRB rule represents another significant milestone in the MSRB's development of the comprehensive regulatory framework for municipal advisors mandated under the Dodd-Frank Act.

On December 23, 2015, the Securities and Exchange Commission (SEC) issued an order approving the Municipal Securities Rulemaking Board's (MSRB) new Rule G-42.¹ New MSRB Rule G-42 sets forth municipal advisors' required standards of conduct and duties when engaging in municipal advisory activities other than municipal advisory solicitation activities. Among other things, the new rule:

- Establishes the standard of conduct a municipal advisor owes its municipal entity clients, including a duty of care and of loyalty, as well as the advisor's obligation to consider the suitability of its recommendations and those of third parties²
- Establishes the standard of care a municipal advisor owes its obligated person clients³
- Requires full and fair disclosure of all material conflicts of interest and legal or disciplinary events material to a client's evaluation of a municipal advisor
- Requires documentation of the municipal advisory relationship and specifies certain aspects of the relationship that must be included in the documentation
- Specifically prohibits a municipal advisor from engaging in certain activities

New MSRB Rule G-42 is similar to the prior MSRB proposal, but, as noted below, modifies the Rule in several important respects regarding the prohibition on principal transactions. MSRB Rule G-42 will become effective on June 23, 2016.

Standards of Conduct

MSRB Rule G-42 establishes the standards of care and duties each municipal advisor is subject to in dealing with obligated person clients and municipal entity clients. Each municipal advisor is subject to a duty of care regarding a client who is an obligated person⁴, and both a duty of care and of loyalty for municipal entity clients.⁵

Under MSRB Rule G-42, the duty of care requires a municipal advisor to (i) exercise due care in performing municipal advisory activities; (ii) possess the degree of knowledge and expertise needed to provide the municipal entity or obligated person client with informed advice; (iii) reasonably inquire as to the facts relevant to a client's determination of whether to proceed with a course of action or that form the basis for any advice provided to the client; and (iv) reasonably determine the municipal advisor is not basing any recommendation on materially inaccurate or incomplete information.⁶

The duty of care also requires the municipal advisor to have a reasonable basis for any:

- Advice provided to or on behalf of a client
- Representations made in a certificate the advisor signs that will be reasonably foreseeably relied upon by the client, any other party involved in the municipal securities transaction or municipal financial product, or investors in the municipal entity client's securities or securities secured by payments from an obligated person client
- Information provided to the client or other parties involved in the municipal securities transaction in connection with preparing an official statement for any issuance of municipal securities the advisor is advising on⁷

Under MSRB Rule G-42, the duty of loyalty requires a municipal advisor (when engaging in municipal advisory activities for a municipal entity) to deal honestly and with the utmost good faith with the client and to act in the client's best interests without regard to the financial or other interests of the municipal advisor.⁸ MSRB Rule G-42 also makes clear that the duty of loyalty would preclude a municipal advisor from engaging in municipal advisory activities with a municipal entity client if it cannot manage or mitigate its conflicts of interest in a manner that will permit the municipal advisor to act in the municipal entity's best interests.⁹

According to the MSRB, its intent in MSRB Rule G-42 is not to set forth every aspect of the duties and obligations that municipal advisors owe to their clients. Instead, MSRB Rule G-42 is designed primarily to set forth the "core elements" of the fiduciary duty and provide guidance on certain conduct that is likely to occur and issues that are likely to arise in the provision of municipal advisory services. Municipal advisors should also note that the required standards under MSRB Rule G-42 do not supersede any more restrictive provisions of state or other laws applicable to the activities of municipal advisors.

Recommendations and Review of Other Parties' Recommendations

Under MSRB Rule G-42, a municipal advisor must not recommend that its client enter into any municipal securities transaction or municipal financial product¹⁰ unless the municipal advisor reasonably believes, based on the information obtained through the advisor's reasonable diligence, that the recommended transaction or product is suitable for the client.¹¹ Should the client request the municipal advisor review and determine the suitability of a third-party recommendation, such review would be subject to the same reasonable diligence standard as if the municipal advisor were making the recommendation.¹²

To comply with these requirements, the municipal advisor must inform its municipal entity or obligated person client of the advisor's evaluation of: (i) the material risks, potential benefits, structure and other characteristics of the recommended municipal securities transaction or municipal financial product; (ii) the basis upon which the advisor reasonably believes the recommended transaction or product is, or is not, suitable for the client; and (iii) whether the municipal advisor has investigated or considered other reasonably feasible alternatives to the recommended municipal securities transaction or municipal financial product that might also or alternatively serve the client's objectives.¹³

The Supplementary Material to MSRB Rule G-42 clarifies that the municipal advisor's determination of whether a municipal securities transaction or municipal financial product is suitable for its client must be based on factors applicable to the particular type of client. These factors include, among others, the client's financial situation and needs, objectives, tax status, risk tolerance, liquidity needs, experience with municipal securities transactions and financial capacity to withstand changes in market conditions during

the term of the municipal financial product or the period that municipal securities to be issued are reasonably expected to be outstanding.¹⁴

MSRB Rule G-42 also imposes a “know your client” obligation similar to requirements under other regulatory regimes,¹⁵ which requires the municipal advisor to use reasonable diligence to know and retain essential facts concerning the client and the authority of each person acting on the client’s behalf.¹⁶

Specified Prohibitions

In addition to imposing the duties and requirements noted above, MSRB Rule G-42 also prohibits a municipal advisor from:

- Receiving excessive compensation
- Delivering inaccurate invoices for fees or expenses
- Providing false or misleading representations about the municipal advisor’s resources, capacity or knowledge
- Participating in certain fee-splitting arrangements with underwriters
- Participating in any undisclosed fee-splitting arrangements with investment or service providers to a municipal entity or obligated person client
- Paying to obtain or retain an engagement to perform municipal advisory activities, with limited exceptions
- Entering into certain principal transactions with the municipal advisor’s municipal entity clients, subject to the exceptions discussed below¹⁷

Principal Transactions

MSRB Rule G-42 prohibits a municipal advisor, and the advisor’s affiliates, from engaging with a municipal entity client in a principal transaction¹⁸ that is the same, or a directly related, issuance of municipal securities or municipal financial product on which the municipal advisor is advising or has advised that municipal entity client.¹⁹ Notably, the prohibition applies only with respect to clients that are municipal entities; it does not apply to principal transactions between a municipal advisor (or affiliate) and the municipal advisor’s obligated person clients.

In response to comments from market participants regarding the principal transaction prohibition’s breadth in the MSRB’s initial proposal, the MSRB adopted a limited exception for transactions in specified fixed income securities (the Fixed Income Exception). Under the Fixed Income Exception, a municipal advisor may engage in principal transactions involving US Treasury securities, agency debt securities²⁰ and corporate debt securities,²¹ provided:

- The municipal advisor is a broker-dealer registered under Section 15 of the Exchange Act, and each account as to which the municipal advisor relies on the Fixed Income Exception is a brokerage account subject to the Exchange Act, and the rules thereunder, and the rules of the self-regulatory organization of which the advisor is a member, and is an account as to which the

municipal advisor exercises no investment discretion except investment discretion a municipal entity client has granted on a temporary or limited basis

- Neither the municipal advisor, nor any affiliate of the municipal advisor, is providing or has provided advice to the municipal entity client regarding an issuance of municipal securities or a municipal financial product that is directly related to the principal transaction (other than advice as to another principal transaction under circumstances meeting all the requirements of the Fixed Income Exception)
- The municipal advisor either: (i) discloses to the municipal entity client in writing before the principal transaction's completion the capacity in which the municipal advisor is acting, and obtains the municipal entity client's consent to such transaction, or (ii) executes the transaction under circumstances satisfying six additional conditions²²

Although the Fixed Income Exception represents a significant departure from the MSRB's initial proposal, whether market participants will find the exception sufficiently broad or workable given the substantial conditions remains unclear.

MSRB Rule G-42 also provides an exception to the prohibition on principal transactions to avoid a possible conflict with existing MSRB Rule G-23, which imposes standards for broker-dealers and municipal securities dealers who act as financial advisors to issuers of municipal securities.²³ The exception provides that the prohibition on principal transactions in MSRB Rule G-42 does not apply to an acquisition as principal, either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from an issuer all or any portion of an issuance of municipal securities on the basis that the municipal advisor provided advice on the issuance, because such a transaction is addressed and prohibited under Rule G-23.²⁴ In response to concerns regarding the scope of this exception, the MSRB clarified that the parameters of the exception are intentionally limited — namely, MSRB Rule G-42 provides an exception for a person acting in compliance with MSRB Rule G-23 only to the specific prohibition on principal transactions in MSRB Rule G-42, and the exception does not prohibit a type of principal transaction that is already addressed and prohibited, to a certain extent, under MSRB Rule G-23. It also does not mean that a transaction not prohibited by MSRB Rule G-23 is deemed in all cases to be lawful under all other requirements of MSRB Rule G-42 (such as the duty of loyalty owed to a municipal entity client) and other laws (such as the statutory fiduciary duty).

Disclosure of Conflicts of Interest and Other Information

MSRB Rule G-42 requires a municipal advisor to fully and fairly disclose to its client in writing all material conflicts of interest, and to do so prior to or upon engaging in municipal advisory activities.²⁵ The Supplementary Material to MSRB Rule G-42 further clarifies that the required disclosures must be sufficiently detailed to inform the client of the nature, implications and potential consequences of each conflict, and must also include an explanation of how the municipal advisor intends to manage or mitigate each conflict.²⁶ According to MSRB Rule G-42, a material conflict of interest that requires disclosure would always include any:

- Affiliate of the municipal advisor that provides any advice, service or product to or on behalf of the client that is directly related to the municipal advisory activities the disclosing municipal advisor is to perform
- Payments the municipal advisor makes, directly or indirectly, to obtain or retain an engagement to perform municipal advisory activities for the client

- Payments the municipal advisor receives from a third party to recommend to the client the third party's services, any municipal securities transaction or any municipal financial product
- Fee-splitting arrangements involving the municipal advisor and any provider of investments or services to the client
- Conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction on which the municipal advisor is advising²⁷

Municipal advisors are also required to disclose any other actual or potential conflicts of interest they are aware of, after reasonable inquiry, that could reasonably be anticipated to impair the advisor's ability to provide advice to or on behalf of a client.²⁸ To the extent a municipal advisor concludes, based on reasonable diligence, the advisor has no known material conflicts of interest, the municipal advisor is required to provide a written statement to the client to that effect.

In addition, a municipal advisor is required to disclose any legal or disciplinary event that would be material to the client's evaluation of the municipal advisor or the integrity of the advisor's management or advisory personnel. This disclosure can be done by identifying the specific type of event and referring the client to the relevant portions of the municipal advisor's most recent SEC Forms MA or MA-I filed with the SEC.²⁹

Documentation of the Municipal Advisory Relationship

MSRB Rule G-42 requires that each municipal advisor evidence each of its municipal advisory relationships in writing upon or promptly after establishing the municipal advisory relationship.³⁰ At a minimum, the municipal advisor's documentation must include:

- The form and basis of direct or indirect compensation, if any, for the municipal advisory activities to be performed
- The conflicts of interest required to be disclosed under MSRB Rule G-42 (noted above)
- A description of the legal and disciplinary events listed on SEC Forms MA and MA-I and where the client may electronically access such forms
- The date of the last material change to the legal or disciplinary event disclosures on any SEC Forms MA or MA-I the municipal advisor filed with the SEC, and a brief explanation of the basis for the materiality of the change or addition
- The scope of the municipal advisory activities to be performed and any limitations on the scope of the engagement
- The date, triggering event or means for terminating the municipal advisory relationship, or, if there are none, a statement to that effect
- Any terms relating to withdrawal from the municipal advisory relationship³¹

Each municipal advisor is also required to promptly amend or supplement the documents required under Rule G-42 during the term of the municipal advisory relationship to reflect any material changes or additions in the required information.³² Significantly, this requirement applies to any changes and

additions that are discovered — or should have been discovered — based on the municipal advisor’s reasonable diligence.³³

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Endnotes

¹ See SEC Release No. 34-76753; File No. SR-MSRB-2015-03 (Dec. 23, 2015), *available at* <http://www.sec.gov/rules/sro/msrb/2015/34-76753.pdf>

² For purposes of MSRB Rule G-42, “municipal entity” has the same meaning as in Section 15B(e)(8) of the Securities Exchange Act of 1934 (Exchange Act) and the rules and regulations promulgated thereunder.

³ Section 15B(e)(10) of the Exchange Act defines “obligated person” as “any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person, committed by contract or other arrangement to support the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities.”

⁴ See MSRB Rule G-42(a)(i).

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- ⁵ See MSRB Rule G-42(a)(ii).
- ⁶ See MSRB Rule G-42, Supplementary Material .01.
- ⁷ See *id.*
- ⁸ See MSRB Rule G-42, Supplementary Material .02.
- ⁹ See *id.*
- ¹⁰ A “municipal financial product” is defined in Exchange Act Section 15B(e)(5) to mean “municipal derivatives, guaranteed investment contracts, and investment strategies,” with each term being further defined by the SEC.
- ¹¹ See MSRB Rule G-42(d).
- ¹² See *id.*
- ¹³ See *id.*
- ¹⁴ See MSRB Rule G-42, Supplementary Material .09.
- ¹⁵ The MSRB specifically noted similar requirements apply to brokers and dealers under Financial Industry Regulatory Authority (FINRA) Rule 2090 (Know Your Customer) and swap dealers under US Commodity Futures Trading Commission (CFTC) Rule 23.402(b) (General Provisions: Know Your Counterparty).
- ¹⁶ See MSRB Rule G-42, Supplementary Material .10.
- ¹⁷ See MSRB Rule G-42(e).
- ¹⁸ For purposes of MSRB Rule G-42, a “principal transaction” is defined as acting as principal for one’s own account, a sale to or a purchase from the municipal entity client of any security or entrance into any derivative, guaranteed investment contract or other similar financial product with the municipal entity client. See MSRB Rule G-42(f)(ix).
- ¹⁹ See MSRB Rule G-42(e)(ii).
- ²⁰ “Agency debt securities” are defined as a debt security (i) issued or guaranteed by an agency, or (ii) issued or guaranteed by a government-sponsored enterprise, including a securitized product that is issued by an agency or a government-sponsored enterprise, or, for which, the principal or interest (or both) is guaranteed by an agency or a government-sponsored enterprise. See MSRB Rule G-42, Supplementary Material .15(b).
- ²¹ “Corporate debt security” means debt security that is US dollar-denominated and issued by a US or foreign private issuer and, if a “restricted security” as defined in SEC Rule 144(a)(3), sold pursuant to SEC Rule 144A, but does not include a money market instrument. See MSRB Rule G-42, Supplementary Material .15(c).
- ²² The six additional conditions include:
- Neither the municipal advisor nor any of its affiliates could be the issuer, or the underwriter (as defined in Exchange Act Rule 15c2-12(f)(8)), of a security that is the subject of the principal transaction
 - The municipal advisor would be required to obtain from the municipal entity client an executed written, revocable consent that would prospectively authorize the municipal advisor directly or indirectly to act as principal for its own account in selling a security to or purchasing a security from the municipal entity client, so long as such written consent were obtained after written disclosure to the municipal entity client explaining: (i) the circumstances under which the municipal advisor directly or indirectly may engage in principal transactions; (ii) the nature and significance of conflicts with the municipal entity client’s interests as a result of the transactions; and (iii) how the municipal advisor addresses those conflicts
 - The municipal advisor, prior to the execution of each principal transaction, would be required to: (i) inform the municipal entity client, orally or in writing, of the capacity in which it may act with respect to such transaction and (ii) obtain consent from the municipal entity client, orally or in writing, to act as principal for its own account with respect to such transaction
 - A municipal advisor would be required to send a written confirmation at or before completion of each principal transaction that includes the information required by Exchange Act Rule 10b-10 or MSRB Rule G-15, and a conspicuous, plain English statement informing the municipal entity client that the municipal advisor: (i) disclosed to the client prior to the execution of the transaction that the municipal advisor may be acting in a principal capacity in connection with the transaction and the client authorized the transaction and (ii) sold the security to, or bought the security from, the client for its own account
 - A municipal advisor would be required to send its municipal entity client, no less frequently than annually, written disclosure containing a list of all transactions that were executed in the client’s account in reliance upon the Fixed Income Exception, and the date and price of the transactions
 - Each written disclosure would be required to include a conspicuous, plain English statement regarding the ability of the municipal entity client to revoke the prospective written consent to principal transactions without penalty at any time by written notice
- ²³ See MSRB Rule G-42, Supplementary Material .08.
- ²⁴ See *id.*
- ²⁵ See MSRB Rule G-42(b).

²⁶ See MSRB Rule G-42, Supplementary Material .05.

²⁷ See MSRB Rule G-42(b)(i)(A)-(E).

²⁸ See MSRB Rule G-42(b)(i)(F).

²⁹ See MSRB Rule G-42(b)(ii).

³⁰ See MSRB Rule G-42(c).

³¹ See *id.*

³² See MSRB Rule G-42, Supplementary Material .06.

³³ See *id.*