HAWKINS ADVISORY

MSRB RULE G-17 INTERPRETIVE NOTICE

On May 4, 2012, the Securities and Exchange Commission (the "SEC") approved[1] an interpretive notice[2] (the "Notice") of the Municipal Securities Rulemaking Board (the "MSRB") regarding the application of MSRB Rule G-17 to municipal securities underwriters. **The Notice will become effective on August 2, 2012.**

Why was the Notice published?

The Notice was published because the MSRB was concerned that not all issuers adequately understand the role of an underwriter in a negotiated sale, and some issuers may have entered into transactions with underwriters for which they did not understand all material financial characteristics.

The Notice is one of a number of recent MSRB initiatives (both rulemaking and interpretations) pursuant to a new expanded mandate to protect municipal issuers. Section 15B of the Securities Exchange Act of 1934 sets forth the purposes to be served by the MSRB rules. Prior to the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] (the "Dodd-Frank Act"), Section 15B provided that the MSRB rules were to "protect investors and the public interest." The Dodd-Frank Act amended Section 15B to add that the MSRB rules were also to protect "municipal entities," which are defined to include "any State, political subdivision of a State, or municipal corporate instrumentality of a State."[4]

Rule G-17 provides as follows:

> In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

The Notice is very comprehensive and should be read in its entirety. A copy of the Notice can be accessed here: http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2012/2012-25.aspx

This Advisory highlights a few key provisions of the Notice. All descriptions of an underwriter's responsibilities and obligations are from the Notice, unless the context makes clear otherwise. In addition, because the MSRB action was an interpretation of a Rule and not an amendment of a Rule, and because many underwriters are already complying with certain of the disclosures required by the Notice, this Advisory describes the requirements of the Notice as if they were already effective.

What it means for Issuers:

An issuer that is involved in a negotiated sale must receive from its underwriter certain statements that describe the underwriter's role and duties. Those statements will generally clarify that the underwriter's primary responsibility is to purchase securities from the issuer at a fair and reasonable price, but that the underwriter does not have a fiduciary duty to the issuer. An underwriter is prohibited from recommending that an issuer not engage a municipal advisor. An underwriter has a duty to deal fairly with the issuer, and a duty to explain complex transactions that it proposes for issuers.

What it means for Underwriters:

An underwriter must make specific, written disclosures to an issuer, and is subject to SEC enforcement actions if it does not.[5] In addition, an underwriter that proposes a complex transaction to an issuer must explain such transaction in a way the issuer understands, and should create a record of those explanations in case questions are raised subsequently about whether the explanations were given and were adequate.

The Notice, subject to limited exceptions, applies only to negotiated underwritings. It applies to dealers acting as underwriters; it does not apply to selling group members.

How will the Notice affect relationships between an issuer and an underwriter?

Many issuers and underwriters have close, long-term relationships, and, in the context of those relationships, the disclosures required by the Notice may seem awkward. However, the Notice generally does not change those relationships; it only makes explicit aspects of those relationships that, from a legal perspective, have long been true. The Notice should, therefore, be regarded as an opportunity for both issuers and underwriters to clarify what

[1] SEC Rel. No. 34-66927 (May 4, 2012).

[2] MSRB Notice 2012-25 (May 7, 2012).

[3] Pub. L. 111-203 (July 21, 2010).

[4] Section 15B(e)(8).

[5] A violation of an MSRB rule is a violation of federal law, enforceable by the SEC. Section 15B(c)(1) of the Securities Exchange Act of 1934.

each can and should expect from the other, so that negotiated sales can proceed appropriately under the Notice.

What the Notice provides:

Fair Dealing Principles. The Notice states that "an underwriter must not misrepresent or omit the facts, risks, potential benefits, or other material information about municipal securities activities undertaken with a municipal issuer." However, it also cautions that "Rule G-17 does not merely prohibit deceptive conduct on the part of the dealer. It also establishes a general duty of a dealer to deal fairly with all persons (including, but not limited to, issuers of municipal securities), even in the absence of fraud."

Mandated Disclosures to Issuer. Rule G-17 requires disclosures to the issuer to clarify the underwriter's role and actual or potential material conflicts of interest, including the following:[6]

- "underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer"
- "unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws"
- "underwriter has a duty to purchase securities from the issuer at a fair and reasonable price"
- "underwriter also must not recommend that the issuer not retain a municipal advisor"
- "underwriter will review the official statement for the issuer's securities in accordance with, and as part of, its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction"
- "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 is unnecessary or to recommend that the size of the transaction be larger than is necessary."
- "underwriter must disclose the material financial characteristics of [a] complex municipal securities financing, as well as the material financial risks of the financing that are known to the underwriter and reasonably foreseeable at the time of the disclosure."[7]
- underwriter must disclose "actual or potential material conflicts of interest," including certain payments to and from third parties, profit-sharing with investors, and credit default swap disclosures

Timing and Manner of Disclosure. The required disclosures must be made in writing to an official of the issuer whom the underwriter reasonably believes has the authority to bind the issuer by contract with the underwriter. The "level of disclosure required may vary according to the issuer's knowledge or experience with the proposed financing structure or similar structures, capability of evaluating the risks of the recommended financing, and financial ability to bear the risks of the recommended financing, in each case based on the reasonable belief of the underwriter."

Certain disclosures are to be made in connection with responses to requests for proposals; others in engagement letters; and others before a bond purchase agreement is executed. For example, disclosures regarding the arm's-length nature of the underwriter-issuer relationship must be made in any response to a request for proposals or in promotional materials provided to an issuer. Other disclosures concerning the role of the underwriter and the underwriter's compensation generally would be made in an engagement letter and not solely in a bond purchase agreement. Prior to the Notice, it was not uncommon for an underwriter to include disclosures regarding the arm's-length nature of the relationship, compensation, and similar matters in the bond purchase agreement. The Notice would require a change in the timing of such practice.

Acknowledgement of Disclosures. The underwriter must attempt to receive written acknowledgement by the official of the issuer of receipt of the required disclosures. If the official of the issuer will not provide written acknowledgement of receipt, the underwriter may proceed with the engagement after documenting with specificity why it was unable to obtain such written acknowledgement.

Compensation. An underwriter's compensation for a new issue may be so disproportionate to the nature of the underwriting and related services performed as to constitute an unfair practice with regard to the issuer that it is a violation of Rule G-17.

Fair Pricing. The duty of fair dealing under Rule G-17 includes an implied representation that the price an underwriter pays to an issuer is fair and reasonable.

Retail Order Periods. Rule G-17 requires an underwriter that has agreed to underwrite a transaction with a retail order period to take reasonable measures to ensure that retail clients are bona fide.

[6] The Notice was issued in proposed form in September 2011 and amended in November 2011. In response to the Notice, the Securities Industry and Financial Markets Association provided model statements for use by underwriters, with the result that certain of the disclosures required by the Notice have been in common use in bond purchase agreements and engagement letters. See SIFMA's Model Clarifying Statements for Municipal Securities Underwriters (Revised November 2011), available on SIFMA's website (www.sifma.org).

[7] The Notice provides: "Examples of complex municipal securities financings include variable rate demand obligation ('VRDOs') and financings involving derivatives (such as swaps)."

Dealer Payments to Issuer Personnel. The Notice reminds dealers of the application of Rule G-17 "in connection with certain payments made to, and expenses reimbursed for, issuer personnel during the municipal bond issuance process" and of Rule G-20 on gifts, gratuities, and non-cash compensation. For example, "a dealer acting as a financial advisor or underwriter may violate Rule G-20 by paying for excessive or lavish travel, meal, lodging and entertainment expenses in connection with an offering . . . that inure to the personal benefit of issuer personnel and that exceed the limits or otherwise violate the requirements of the rule."

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