MSRB
Municipal Securities Rulemaking Board

Regulatory Notice

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Stakeholders
Municipal Advisors, Issuers, General Public

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Request for Comment

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March 10, 2014

Category
Fair Practice

Affected Rules
Rule G-8; Rule G-9

Request for Comment on Draft MSRB Rule G-42, on Duties of Non-Solicitor Municipal Advisors

Overview

The Municipal Securities Rulemaking Board ("MSRB") is seeking comment on draft Rule G-42 on standards of conduct and duties of municipal advisors when engaging in municipal advisory activities other than the undertaking of solicitations. The MSRB is also seeking comment on associated draft amendments to Rules G-8, on books and records, and G-9, on the preservation of records.

Comments should be submitted no later than March 10, 2014, and may be submitted in electronic or paper form. Comments may be submitted electronically by clicking here. Comments submitted in paper form should be sent to Ronald W. Smith, Corporate Secretary, Municipal Securities Rulemaking Board, 1900 Duke Street, Suite 600, Alexandria, Virginia 22314. All comments will be available for public inspection on the MSRB's website.[1]

Questions about this notice should be directed to Michael L. Post, Deputy General Counsel, or Kathleen Miles, Associate General Counsel, at 703-797-6600.

Background

In the aftermath of the financial crisis of 2008, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] Congress, among other things, amended Section 15B of the Securities Exchange Act of 1934 ("Exchange Act") to provide for the

[1] Comments are posted on the MSRB website without change. Personal identifying information such as name, address, telephone number, or email address will not be edited from submissions. Therefore, commenters should only submit information that they wish to make available publicly.

[2] Pub. Law No. 111-203, 124 Stat. 1376 (2010).

regulation by the Securities and Exchange Commission ("SEC") and the MSRB of municipal advisors[3] and to grant the MSRB certain authority to protect municipal entities[4] and obligated persons.[5] The Dodd-Frank Act accordingly grants the MSRB broad rulemaking authority over municipal advisors and municipal advisory activities.[6] The Dodd-Frank Act's legislative history indicates Congress was concerned that the municipal securities market had

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[3] Section 15B(e)(4)(A) of the Exchange Act defines the term "municipal advisor" to mean, in relevant part and subject to certain exceptions,

> a person (who is not a municipal entity or an employee of a municipal entity) that (i) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or (ii) undertakes a solicitation of a municipal entity.

As noted below, the SEC has adopted final rules on the registration of municipal advisors that sets out the SEC's definition of "municipal advisor" to which the municipal advisor regulatory regime is to apply. The term "municipal advisor" is used in this notice, draft Rule G-42 and the associated amendments to Rules G-8 and G-9 with the same meaning as set forth in the SEC definition, but excluding solicitors.

[4] Section 15B(e)(8) of the Exchange Act defines the term "municipal entity" to mean:

> any State, political subdivision of a State, or municipal corporate instrumentality of a State, including ---- (A) any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities.

[5] Section 15B(e)(10) of the Exchange Act defines the term "obligated person" to mean:

> 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.

[6] Section 15B(b)(2) of the Exchange Act provides that

> [t]he 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.

been subject to less regulation than corporate securities markets, and particularly that "[d]uring the [financial] crisis, a number of municipalities suffered losses from complex derivatives products that were marketed by unregulated financial intermediaries."[7] The regulation of municipal advisors and their advisory activities is, as the SEC has recognized, generally intended to address problems observed with the conduct of some municipal advisors, "including 'pay to play' practices, undisclosed conflicts of interest, advice rendered by financial advisors without adequate training or qualifications, and failure to place the duty of loyalty to their clients ahead of their own interests."[8]

As discussed in more detail below, the Dodd-Frank Act itself specifically establishes that a fiduciary duty is owed by a municipal advisor to its municipal entity clients.[9] By contrast, the Dodd-Frank Act does not impose a fiduciary duty with respect to a municipal advisor's obligated person clients.[10]

The SEC and MSRB have developed registration regimes for municipal advisors. In September 2010, the SEC adopted, and subsequently extended, a temporary registration program for municipal advisors.[11] In November 2010, the MSRB amended its rules to require municipal advisors to register with the MSRB.[12] Any municipal advisor engaging in municipal advisory activities

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[7] S. Rep. No. 111-176, at 38 (2010).

[8] Exchange Act Release No. 34-70462, (September 20, 2013), 78 FR 67468 (November 12, 2013) ("SEC Final Rule") at 67469; *see id.* at 67475 nn.104-6 and accompanying text (discussing relevant enforcement actions). *See also*, MSRB, Unregulated Municipal Market Participants—A Case for Reform, April 2009, http://www.msrb.org/Market-Disclosures-and-Data/Market-Statistics/~/media/Files/Special-Publications/MSRBReportonUnregulatedMarketParticipants_April09.ashx.

[9] Section 15B(c)(1) of the Exchange 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.

[10] *See* SEC Final Rule at 67475 n.100.

[11] *See* Exchange Act Release No. 34-62824 (September 1, 2010); 75 FR 54465 (September 8, 2010).

[12] *See* Exchange Act Release No. 34-63308 (November 12, 2010); 75 FR 70335 (November 17, 2010).

after December 31, 2010, without registering with the MSRB is in violation of MSRB rules.[13] In December 2010, the SEC proposed a permanent registration regime for municipal advisors.[14]

Recently, on September 18, 2013, the SEC acted on that proposal and adopted final rules to, among other things, define who is a municipal advisor, establish a permanent registration regime for that defined set of persons, and establish basic recordkeeping requirements for such advisors ("SEC Final Rule").[15] The SEC Final Rule, scheduled to take effect January 13, 2014, differs significantly from the original proposal in many respects. For example, the SEC Final Rule generally expands the scope of the exclusions and exemptions from the definition of municipal advisor, and provides additional guidance to market participants about what constitutes "advice."

With the adoption of the SEC Final Rule, the MSRB has formally re-engaged in its development of a regulatory framework for municipal advisors. A cornerstone of that regulatory framework is draft Rule G-42 establishing certain core standards of conduct and duties of municipal advisors,[16] other than when engaging in solicitation activities.[17]

The Exchange Act, as amended by the Dodd-Frank Act, contains several grants of rulemaking authority that form the statutory basis for this rulemaking initiative. Section 15B(b)(2) directs the MSRB to undertake certain rulemaking with respect to brokers, dealers, and municipal securities

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[13] *See* MSRB Notice 2010-50 (November 15, 2010).

[14] Exchange Act Release No. 34-63576 (December 20, 2010), 76 FR 824 (January 6, 2011).

[15] *See supra* note 10.

[16] SEC Final Rule at 67519 n.679 (recognizing that the regulation of municipal advisors includes the "application of standards of conduct . . . that may be required by the Commission or the MSRB, and other requirements unique to municipal advisors that may be imposed by the MSRB").

[17] Draft Rule G-42 does not address the duties of a municipal advisor when undertaking a solicitation of a municipal entity or obligated person within the meaning of Section 15B(e)(9) of the Exchange Act and the rules and regulations thereunder. The MSRB intends to undertake separate rulemaking with regard to solicitation activities, which may raise issues particular to those activities, at a later date. Municipal advisors engaged in such activities are reminded that they currently are subject to the MSRB's basic fair practice rule, Rule G-17, which applies to all municipal advisors as well as to brokers, dealers and municipal securities dealers.

dealers ("dealers") and municipal advisors who provide advice to or on behalf of municipal entities and obligated persons with respect to municipal financial products and the issuance of municipal securities.[18] Such rulemaking includes, under Section 15B(b)(2)(L)(i), the establishment of rules with respect to municipal advisors to accomplish several ends, including "prescrib[ing] 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." Section 15B(b)(2)(C) grants the MSRB authority to adopt rules to prevent fraud and in general to protect investors, municipal entities, obligated persons, and the public interest.

Previously, in the exercise of its rulemaking authority under the Dodd-Frank Act, the MSRB amended Rule G-17 on fair dealing to provide that municipal advisors, in the conduct of their municipal advisory activities, must deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice.[19]

Summary of Draft Rule G-42 and the Draft Amendments to Rules G-8 and G-9

Draft Rule G-42 (Duties of Non-Solicitor Municipal Advisors) sets forth the basic duties and responsibilities of a municipal advisor. The regulatory regime for municipal advisors includes a fiduciary duty and other standards of conduct.[20] As noted by the SEC, however, Section 975 of the Dodd-Frank Act did not define the contours of a municipal advisor's fiduciary duty. In addition, the SEC did not undertake to define the fiduciary duty or other standards of conduct of a municipal advisor as part of its Final Rule.[21]

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 approach towards fiduciary duties in draft Rule G-42 flows from the distinctions drawn in the Dodd-Frank Act between a municipal advisor's duties owed to clients that are municipal entities on the one hand, and obligated persons, on the other. In practice, under many circumstances, these distinctions may not be material insofar as municipal advisors have,

[18] *See* supra note 7.

[19] *See* Exchange Act Release No. 34-63599; File No. SR-MSRB-2010-16 (December 22, 2010).

[20] *See* SEC Final Rule at 67519 n.679.

[21] *See* SEC Final Rule at 67475 n.100.

with respect to all clients, a duty of care and a duty to deal fairly and to not engage in any deceptive, dishonest, or unfair practice.[22] Nevertheless, as discussed below, the MSRB invites comment on whether draft Rule G-42 appropriately limits the application of the fiduciary duty to municipal advisors' municipal entity clients, or should extend such fiduciary duty to all clients, including obligated persons, under the MSRB's issuer protection mandates.

Irrespective of any fiduciary duties, draft Rule G-42 subjects municipal advisors to a duty of care in the conduct of their municipal advisory activities. In addition, draft Rule G-42 requires municipal advisors to disclose conflicts of interest and certain other information to their clients and document their municipal advisory relationship. Draft Rule G-42 does not permit a municipal advisor to recommend that a client enter into any municipal securities transaction or municipal financial product unless the advisor has a reasonable basis for believing that the transaction or product is suitable for the client. If engaged to do so by its client, a municipal advisor also would be required to undertake a review of a recommendation made by a third party regarding a municipal securities transaction or municipal financial product. Draft Rule G-42 prohibits a municipal advisor (and any affiliate) from engaging in any transaction in a principal capacity to which the municipal entity or obligated person client of the municipal advisor is a counterparty, except for activity that is expressly permitted by underwriters under Rule G-23. The draft rule also enumerates certain other prohibited activities.

Draft Rule G-42 includes Supplementary Material that provides additional guidance on such topics as: aspects of the duty of care, aspects of the duty of loyalty, responsibilities if a client pursues an action independent of or contrary to advice provided by a municipal advisor, limitations of the scope of the municipal advisory engagement, and the requirements to provide certain disclosures to investors. The Supplementary Material also includes provisions specifically addressing the suitability of recommendations and the requirement to know one's client.

Draft Rule G-42 includes definitions, for purposes of the rule, of "advice," "affiliate of the municipal advisor," "municipal advisor, ""municipal advisory activities," "municipal advisory relationship," "municipal advisory business," "municipal entity," "obligated person," and "official statement." The terms "advice," "municipal advisor," "municipal advisory activities," "municipal entity," and "obligated person" are based upon the interpretations of statutory definitions given in the SEC Final Rule.

[22] *See* SEC Final Rule at 67511 n.574 and accompanying text.

The draft amendments to MSRB Rules G-8 (on books and records) and G-9 (on preservation of records) require, by reference, the keeping of all of the records required by the SEC Final Rule. In addition, the draft amendments to Rule G-8 would include specific recordkeeping requirements that would correspond to certain specific requirements of draft Rule G-42 that are not necessarily covered by the SEC Final Rule. The draft amendments to Rule G-9 require municipal advisors generally to preserve records for not less than five years.

The MSRB requests comment on draft Rule G-42 and the associated draft amendments to Rules G-8 and G-9.

Request for Comment

Standards of Conduct
Under draft Rule G-42(a), each municipal advisor in the conduct of its municipal advisory activities for an obligated person client is subject to a duty of care. Each municipal advisor in the conduct of its municipal advisory activities on behalf of a municipal entity client is subject to a fiduciary duty, which includes, without limitation, a duty of care and a duty of loyalty.

The Supplementary Material in the draft rule provides guidance on the meaning of the duty of care and the duty of loyalty. The duty of care, as described in Supplementary Material .01, means, without limitation, that a municipal advisor must: (a) exercise due care in performing its municipal advisory activities; (b) possess the degree of knowledge and expertise needed to provide the client with informed advice; (c) make a reasonable inquiry as to the facts that are relevant to a client's determination as to whether to proceed with a course of action or that form the basis for any advice provided to the client; and (d) undertake a reasonable investigation to determine that the municipal advisor is not basing any recommendation on materially inaccurate or incomplete information. In addition, a municipal advisor that is engaged by a client in connection with either an issuance of municipal securities or a municipal financial product that is related to an issuance of municipal securities must also undertake a thorough review of the official statement for that issue unless otherwise directed by the client and so documented in writing.

The duty of loyalty, as described in Supplementary Material .02, requires, without limitation, a municipal advisor to deal honestly and with the utmost

good faith with a municipal entity client and act in the client's best interests without regard to the financial or other interests of the municipal advisor.

As a general matter, the duties created by the draft rule would be, as provided in Supplementary Material .06, in addition to any state law or other duties, including fiduciary duty laws.

Disclosure of Conflicts of Interest and Other Information

Draft Rule G-42(b) requires a municipal advisor to fully and fairly disclose to its client in writing all material conflicts of interest, and to do so at or prior to the inception of a municipal advisory relationship. These include any actual or potential conflict of interest that might impair the advisor's ability to render unbiased and competent advice to or on behalf of the client.

To aid municipal advisors in meeting these disclosure obligations, draft Rule G-42(b) includes a non-exhaustive list of specific items requiring disclosure. These items include the provision by any affiliate of certain advice, services, or products to or on behalf of the client; payments to obtain or retain the client's municipal advisory business; payments received from third parties to enlist the municipal advisor's recommendations; any fee-splitting arrangements with any provider of investments or services to the client; conflicts that may arise from the use of the form of compensation under consideration or selected by the client; and any other engagements or relationships of the municipal advisor or any affiliate that might impair the advisor's ability either to render unbiased and competent advice to or on behalf of the client or to fulfill its fiduciary duty to the client, as applicable. Draft Rule G-42(b) also requires disclosure of the amount and scope of coverage of professional liability insurance that the municipal advisor carries (*e.g.*, coverage for errors and omissions, improper judgments, or negligence), deductible amounts, and any material limitations on such coverage, or a statement that the advisor does not carry any such coverage. Finally, draft Rule G-42(b) requires disclosure of any legal or disciplinary event that is (a) material to the client's evaluation of the municipal advisor or the integrity of its management or advisory personnel; (b) disclosed by the municipal advisor on the most recent Form MA filed with the SEC; or (c) disclosed by the municipal advisor on the most recent Form MA-I filed with the SEC regarding any individual actually engaging in or reasonably expected to engage in municipal advisory activities in the course of the engagement.

Paragraph .05 of the Supplementary Material provides that the conflicts 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 advisor addresses or intends to manage or mitigate each conflict.

Documentation of the Municipal Advisory Relationship

Under draft Rule G-42(c), municipal advisors must evidence each of their municipal advisory relationships by a writing entered into prior to, upon or promptly after the inception of the municipal advisory relationship. The documentation would be required to include, at a minimum, certain key terms and disclosures: (i) the form and basis of direct or indirect compensation, if any; (ii) the reasonably expected amount of any such compensation (stated in dollars to the extent it can be quantified); (iii) the scope of municipal advisory activities to be performed and any limitations on the scope of the engagement; (iv) in the case of municipal advisory activities relating to a new issue or reoffering of municipal securities, the specific undertakings, if any, requested by the client to be performed by the advisor relating to the preparation or finalization of the official statement or similar disclosure document; and (v) certain terms relating to the termination of the municipal advisory relationship or, if there are no such terms, then a statement to that effect. Section (c) also requires the relationship documentation to include the conflict and other information required to be disclosed by section (b).

Draft Rule G-42(c) requires that the municipal advisor amend or supplement the writing during the term of the municipal advisory relationship as necessary to reflect changes in or additions to the terms or information required to be disclosed by section (b) or (c). For example, if the basis of compensation or scope of services changed during the term of the relationship, the municipal advisor would be required to amend or supplement the writing. The same would be true in the case of material conflicts of interest discovered after the initial writing had been provided or entered into. To avoid the necessity for amendments or supplementation based on very minor changes in the amount of reasonably expected compensation, a revised writing would only be required on the basis of a change that is material. The amendment and supplementation requirement in draft Rule G-42(c) applies to any changes and additions that are discovered, or should have been discovered, based on the exercise of reasonable diligence by the municipal advisor.

Draft Rule G-42(c) is modeled in part on MSRB Rule G-23, which requires that a dealer that enters into a financial advisory relationship with an issuer must evidence that relationship in writing prior to, upon, or promptly after the relationship has been entered into. The writing would not need to be a two-party agreement. For example, if state law provided for the procurement of

municipal advisory services in a manner that did not include a bilateral agreement, the municipal advisor could send a letter referencing the procurement document and containing the terms and disclosures that would be required by draft Rule G-42(b) and (c).

Because in some cases a client may have already reached a decision regarding a particular type of municipal securities transaction or financial product, and in other cases a client may have engaged another professional to undertake certain duties in connection with a municipal securities transaction, Supplementary Material .04 provides that a municipal advisor and its client may limit the scope of the municipal advisory relationship to certain specified activities or services. The municipal advisor, however, is not permitted to alter the standards of conduct or duties imposed by the draft rule with respect to that limited scope.

Review of the Official Statement

Except for the default requirement pursuant to the duty of care to review thoroughly the official statement, the draft rule does not prescribe specific responsibilities to be undertaken with regard to the official statement. Draft Rule G-42(c)(iv) reflects the MSRB's view that it is generally the prerogative of the client to determine the scope of the municipal advisory activities to be performed by the advisor and any limitations on the scope of the engagement. Draft Rule G-42(c)(v) would require that the specific undertakings, if any are requested by the client to be performed by the advisor with respect to the preparation and finalization of the official statement or similar document, be included in the documentation of the municipal advisory relationship. The provisions of draft Rule G-42(c)(v) may encourage the client to consider at the outset of the transaction whether and to what extent the client wants the municipal advisor to have responsibilities with regard to the official statement or similar disclosure document in light of the particular circumstances of the transaction, including the roles of any other parties involved (*e.g.*, disclosure counsel, bond counsel, swap counsel or counsel to the obligated person). If the municipal advisor and client so agree, they may exclude from the scope of the municipal advisory relationship the default requirement to thoroughly review the official statement.

Disclosure to Investors

Paragraph .07 of the Supplementary Material requires that the municipal advisor provide written disclosure to investors of any affiliation that meets the requirements of subsection (b)(ii) of the draft rule, if a document prepared by the municipal advisor or the affiliate is included in an official statement for an issue of municipal securities (*e.g.*, accountant's letter, bond

opinion, feasibility study). This requirement would be satisfied if the municipal advisor's affiliate were to provide written disclosure of the affiliation to investors. For example, if the advisor for a bond issue were affiliated with the accounting firm that would certify as to the issuer's financial statements, the disclosure of affiliation could be included in the accounting firm's letter to the issuer or disclosures concerning the accounting firm, which would be included in the official statement for the bonds. The purpose of these disclosures would be to alert investors to the affiliation.[23]

Recommendations

Section (d) provides that a municipal advisor must not recommend that its client enter into any municipal securities transaction or municipal financial product unless the advisor has a reasonable basis for believing that the transaction or product is suitable for the client. The advisor also is required to discuss with its client its evaluation of the material risks, potential benefits, structure and other characteristics of the recommended municipal securities transaction or municipal financial product; the basis upon which the advisor reasonably believes the recommended transaction or product is suitable for the client and whether the municipal advisor has investigated or considered other reasonably feasible alternatives. With respect to a municipal entity client, the advisor must only recommend a transaction or product that is in the municipal entity client's best interest.

Paragraph .08 of the Supplementary Material provides guidance related to an advisor's suitability obligations. Under that provision, a municipal advisor's determination of whether a municipal securities transaction or municipal financial product is suitable for the client must be based on numerous factors: the client's financial situation and needs, objectives, tax status, risk tolerance, liquidity needs, experience with municipal securities transactions or municipal financial products, financial capacity to withstand changes in market conditions and any other material information known by the municipal advisor about the client and the municipal securities transaction or municipal financial product, after reasonable inquiry.

Paragraph .09 of the Supplementary Material includes a "Know Your Client" obligation which, drawing upon similar rules adopted by the Financial Industry Regulatory Authority ("FINRA") and the Commodity Futures Trading

[23] The draft amendments to Rule G-8 provide that, if the disclosure of the affiliation to investors is not provided in the official statement, the records of the municipal advisor must include a copy of the disclosure provided by the municipal advisor or its affiliate to such investors.

Commission ("CFTC"), requires the advisor to use reasonable diligence to know and maintain essential facts concerning the client and in support of the advisor's fulfillment of its suitability obligations.[24] The facts "essential" to "knowing your client" include those required to effectively service the municipal advisory relationship with the client; act in accordance with any special directions from the client; understand the authority of each person acting on behalf of the client; and comply with applicable laws, regulations and rules.

As a practical matter, a client may at times elect a course of action either independent of or contrary to the advice of its municipal advisor. Paragraph .03 of the Supplementary Material would provide that the advisor is not required *on that basis* to disengage from the municipal advisory relationship.

Review of Recommendations of Other Parties

Section (e) addresses situations when a municipal advisor may be asked to evaluate a recommendation made to its client by another party, such as a recommendation by an underwriter to an obligated party of a new financial product or financing structure. Draft Rule G-42(e) requires that a municipal advisor, if requested to do so and if the review of others' recommendations is within the scope of the engagement, discuss with its client its evaluation of the material risks, potential benefits, structure and other characteristics of the recommended municipal securities transaction or municipal financial product. The advisor would also be required to discuss with the client whether the advisor reasonably believes that the recommended transaction or product is, or is not, suitable for the client and the basis for such belief, as well as whether the municipal advisor has investigated or considered other reasonably feasible alternatives.

Principal Transactions

Section (f) prohibits a municipal advisor, and any affiliate of a municipal advisor, from engaging in any transaction in a principal capacity to which the municipal entity or obligated person client of the municipal advisor is a counterparty. To avoid a conflict with another MSRB rule, an exception is

[24] *See, e.g.,* FINRA Rule 2090 (Know Your Customer), Exchange Act Release No. 34-63325; SR-FINRA-2010-039 (November 17, 2010), 75 FR 71479 (November 23, 2010) and the CTFC's Subpart H-Business Conduct Standards for Swap Dealers and Major Swap Participants Dealing with Counterparties, including Special Entities, 17 CFR § 23.402(b), 77 FR 9823 (February 17, 2012). Notably, the CFTC's rule applies to dealings with special entity clients, defined to include states, state agencies, cities, counties, municipalities, other political subdivisions of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State. *See* the definition of special entity in 17 CFR § 23.401(c).

allowed for activity that is expressly permitted by underwriters under Rule G-23. The MSRB notes that principal transactions by municipal advisors is an area of particular concern and has proposed to prohibit such transactions rather than allow them with the client's consent. It is questionable whether, given the high potential for self-dealing in such situations, a client consent following any amount of disclosure should be considered to be valid. Comment on whether this is the appropriate regulatory approach to principal transactions is requested below.

Specified Prohibitions

Draft Rule G-42(g) specifically prohibits certain types of activities by a municipal advisor, including: receiving excessive compensation; delivering an invoice for fees or expenses that does not accurately reflect the municipal advisory activities actually performed or the personnel that actually performed those services; misrepresenting its capacity, resources and knowledge in response to requests for proposals or qualifications or in oral presentations to a client or prospective client; making or participating in any fee-splitting arrangements with underwriters; and making or participating in any undisclosed fee-splitting arrangements with providers of investments or services to a client of the municipal advisor. In addition, a municipal advisor would be prohibited from making payments for the purpose of obtaining or retaining municipal advisory business, other than reasonable fees paid to another municipal advisor (registered as such with both the SEC and MSRB) for a solicitation of a municipal entity or obligated person as described in Section 15B(e)(9) of the Exchange Act.

Applicability to Municipal Fund Securities

The regulation of municipal advisors, as the SEC has recognized,[25] is relevant to municipal fund securities.[26] Paragraph .10 of the Supplementary Material highlights the draft rule's application to municipal advisors whose municipal advisory clients are sponsors or trustees of municipal fund securities.

[25] SEC Final Rule at 67472-67473.

[26] The term "municipal fund security" refers to, among other things, interests in governmentally sponsored 529 college savings plans and local government investment pools and is defined in MSRB Rule D-12 to mean "a municipal security issued by an issuer that, but for the application of Section 2(b) of the Investment Company Act of 1940, would constitute an investment company within the meaning of Section 3 of the Investment Company Act of 1940."

Books and Records

The draft provisions on record-keeping would be the first revisions to Rules G-8 and G-9 to address the books and records that must be made and preserved by municipal advisors registered or required to be registered with the MSRB. The SEC Final Rule already establishes a comprehensive record-keeping and preservation regime for municipal advisors that requires records, related to municipal advisory activities, of:

- all written communications received and sent by such municipal advisor;
- each version of all policies and procedures of the municipal advisor;
- any document created by the municipal advisor that was material to the making of a recommendation to a client or that memorializes the basis for that recommendation;
- all written agreements entered into by the municipal advisor with any municipal entity, employee of a municipal entity, or an obligated person or otherwise relating to the business of such municipal advisor; and
- the names of associated persons.

The draft amendments to Rules G-8 and G-9 incorporate by reference all of these record-keeping provisions of the SEC Final Rule. The draft amendments, in addition, include requirements that correspond to certain specific requirements of draft Rule G-42 that are not necessarily covered by the SEC Final Rule. This includes keeping a copy of any document created by a municipal advisor that was material to its review of a recommendation made by another party. This also includes the keeping of any document that memorializes the basis for any conclusions of the municipal advisor as to suitability. Finally, this includes, unless it is included in the official statement for an issue of municipal securities, a copy of any disclosure provided by the municipal advisor, or any affiliate, to investors as required by Supplementary Material .07.

The draft amendments to Rule G-9 require records to be preserved for not less than five years—the same period required by the SEC Final Rule. In addition, the draft amendments to Rule G-9(e) expressly provide that municipal advisors may retain records using electronic storage media or by other similar medium of record retention, subject to the retrieval and reproduction requirements of the rule. The provision for this means of compliance is made generally applicable, so as to expressly accommodate the use of electronic storage media by dealers as well as municipal advisors. Draft section (k) of Rule G-9 provides that whenever a record is preserved by a municipal advisor on electronic storage media, if the manner of storage

complies with SEC Rule 15a1-8(d) under the Exchange Act, it will be deemed to be preserved in a manner that is in compliance with the requirements of Rule G-9. This provision gives municipal advisors the choice to comply with either the SEC's or the MSRB's preservation requirements.

General Matters

In addition to any other subject which commenters may wish to address related to draft Rule G-42 and the draft amendments to Rules G-8 and G-9, the MSRB seeks public comment on the specific questions below. The MSRB particularly welcomes statistical, empirical, and other data from commenters that may support their views and/or support or refute the views or assumptions contained in this request for comment.

1) Draft Rule G-42 follows the Dodd-Frank Act in deeming a municipal advisor to owe a fiduciary duty, for purposes of the draft Rule G-42, only to its municipal entity clients. Is carrying forward that distinction in the draft rule appropriate in light of the services a municipal advisor provides to its obligated person clients? Would having a uniform fiduciary standard applied to *all* of a municipal advisor's clients facilitate compliance with the draft rule or provide better protection for issuers? If so, are there any legal impediments to the MSRB extending a fiduciary duty in the draft rule to all clients of a municipal advisor?

2) Do commenters agree that a municipal advisor that is engaged by a client in connection with either an issuance of municipal securities or a municipal financial product that is related to an issuance of municipal securities should have an obligation, unless agreed to otherwise by the advisor and client, to review thoroughly the entire official statement? Should a municipal advisor be permitted to limit the scope of the engagement such that the advisor is not required to review the official statement? If so, under what circumstances should this limitation be allowed? Should any duty to review the official statement be limited to any portions of the official statement directly related to the scope of municipal advisory services?

3) Would draft Rule G-42(c)(vi) have benefits in terms of encouraging municipal entity and obligated person clients to carefully consider at the outset of a transaction any obligations it may have in connection with the preparation and distribution of the official statement and the extent to which it has engaged professionals, as necessary, to assist it in fulfilling its responsibilities?

4) Do commenters agree or disagree that there is a need to specifically require disclosure of conflicts of interest that may arise from the form of

compensation under consideration by the client and/or selected by the client?

5) Draft Rule G-42 allows fee-splitting arrangements with providers of investments or services to a municipal entity or obligated person client, but requires written full and fair disclosure of the arrangement. Should such fee-splitting arrangements be prohibited, regardless of whether they are fully and fairly disclosed?

6) Is draft Rule G-42(b)'s requirement that the disclosure of conflicts of interest and other information be provided at or prior to the inception of the municipal advisory relationship the appropriate timeframe?

7) Should a municipal advisor be required to obtain a written acknowledgment from the client of receipt of the conflicts disclosure and consent to any conflicts disclosed before proceeding with a municipal advisory engagement?

8) Should a municipal advisor be required to disclose legal and disciplinary events that relate to an individual that is employed by the municipal advisor even if the individual is not a part of (or reasonably expected to be part of) the advisor's team working for the client?

9) Should the MSRB, in furtherance of its mandate under the Dodd-Frank Act to protect municipal entities and obligated persons, require professional liability insurance by municipal advisors, and, if so, should the MSRB specify the minimum amount and terms of such coverage?

10) Would the cost of professional liability insurance be an undue barrier to entry for a potential municipal advisor?

11) Should an advisor be required to review any feasibility study as a part of the information considered in its evaluation of whether a transaction it recommends is suitable for the client?

12) Should a municipal advisor (or its affiliate) be permitted to engage in certain types of principal transactions with its client, with full and fair disclosure and written client consent? If so, what types of principal transactions should be allowed?

13) Should the treatment of principal transactions differ based upon whether a municipal advisor has a fiduciary duty to the client?

Economic Analysis

In proposing draft Rule G-42 and the draft amendments to Rules G-8 and G-9, the MSRB has been guided by its policy on the use of economic analysis in rulemaking. The MSRB is sensitive to the costs imposed by its rules and has sought to tailor the draft rule and amendments so as not to impose unnecessary or inappropriate costs and burdens on municipal advisors. In accordance with this policy, the Board considered the following factors with respect to draft Rule G-42 and the draft amendments to Rules G-8 and G-9: 1) the need for the draft rule and how the draft rule will meet that need; 2) relevant baselines against which the likely economic impact of elements of the draft rule can be considered; 3) reasonable alternative regulatory approaches; and 4) the potential benefits and costs of the draft rule and the main alternative regulatory approaches. Each of these factors is discussed in detail below.

1. **The need for the draft rule and how the draft rule will meet that need.**

Prior to the enactment of the Dodd-Frank Act, municipal advisors were largely unregulated as to their municipal advisory activities.[27] As noted, the Dodd-Frank Act amends the Exchange Act to provide new protections for municipal entities and obligated persons in connection with the issuance of, or the investment of the proceeds of, municipal securities, and to grant the MSRB a role in the protection of municipal entities and obligated persons. 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 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

[27] Prior to the Dodd-Frank Act, certain MSRB rules applied to a subset of municipal advisors consisting of dealers acting as financial advisors in connection with new issues of municipal securities.

prevention of breaches of a municipal advisor's fiduciary duty to its municipal entity clients.

Draft Rule G-42 also establishes standards of conduct and duties for municipal advisors when engaging in municipal advisory activities for obligated persons and provides guidance to these advisors as to what conduct would satisfy these duties and obligations.

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.

2. Relevant baselines against which the likely economic impact of elements of the draft rule can be measured.

In considering the economic consequences of draft Rule G-42 and the draft amendments to Rules G-8 and G-9, the MSRB has defined and analyzed several baselines to serve as points of reference. Given that the draft rule contains many different elements, the MSRB has considered a separate baseline for one or more different elements. The purpose of the baselines is to compare, on the one hand, the expected state with draft Rule G-42 in effect to, on the other hand, the baseline state prior to the rule taking effect. The economic impact of the draft rule is considered to be the difference between these two states.

For draft Rule G-42, one relevant baseline for analysis is the Dodd-Frank Act, which subjected municipal advisors to a statutory fiduciary duty with respect to municipal entity clients. The MSRB considers the obligations imposed by this duty to be a baseline, such that the costs and benefits of draft Rule G-42 should be measured by any change from this existing state. 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 considers MSRB Rule G-17 to be a relevant baseline for the standards of conduct and duties for municipal advisors when engaging in municipal advisory activities for obligated persons. This rule, as amended in 2010, requires municipal advisors to deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice. Although Rule G-17 applies to all municipal advisors, the MSRB does not regard it as the baseline for municipal advisors with municipal entity clients because the fiduciary duty imposed by the Dodd-Frank Act represents a higher baseline state for these municipal advisors. Draft Rule G-42 can be viewed, to a certain extent, as articulating guidance on the conduct required for municipal advisors to meet their existing duty to deal fairly with all persons (including obligated persons).

The Dodd-Frank Act prohibits municipal advisors from engaging in any fraudulent, deceptive, or manipulative act or practice, as pertinent here, in connection with providing advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities. The MSRB considers this prohibition also to serve as a baseline for standards of conduct for municipal advisors.

A subset of municipal advisors who are also dealers are subject to MSRB Rule G-23 which establishes requirements with respect to the conflict of interest that can arise in the context of dealers who may seek to switch roles between financial advisor and underwriter to issuers with respect to the issuance of municipal securities. In particular, Rule G-23(c) provides that a dealer that enters into a financial advisory relationship must evidence that relationship in writing prior to, upon, or promptly after the relationship has been entered into. Rule G-23 also prohibits a dealer that has a financial advisory relationship with the issuer in connection with a new issue from acting as an underwriter or placement agent for such new issue. For this subset of municipal advisors, the applicable set of standards and requirements of Rule G-23 is considered by the Board to be a baseline.

In addition to the Dodd-Frank Act and the MSRB's existing rules, the SEC Final Rule on registration of municipal advisors provides baselines for particular elements of draft Rule G-42. The SEC Final Rule requires disclosure in registration forms of certain disciplinary history and conflicts of interest. Draft Rule G-42 requires disclosure of at least some similar information. Although draft Rule G-42 would require disclosure directly to clients rather than through submissions to a regulator, the MSRB considers the SEC Final Rule to serve as a relevant baseline.

Another relevant consideration when analyzing the duties under draft Rule G-42 is current state law. For example, to the extent that municipal advisors owe a fiduciary duty to their clients under the laws of at least some states,[28] the MSRB regards these laws as a baseline.

Finally, the MSRB considers existing requirements in the SEC Final Rule on recordkeeping and record preservation to serve as a baseline. These requirements are the existing state against which additional requirements by the MSRB can be compared. In addition, municipal advisors who are also registered as dealers or investment advisors are subject to recordkeeping requirements under those regulatory regimes that can serve as baseline requirements for that subset of the municipal advisor population.

3. Identifying and evaluating reasonable alternative regulatory approaches.

The MSRB policy on economic analysis in rulemaking addresses the identification and evaluation of reasonable regulatory alternatives.

One alternative to the draft rule would be for the MSRB not to engage in additional rulemaking, and thus, not establish guidance with respect to the duties and obligations of municipal advisors. Under this alternative, the needs of municipal advisors for guidance on avoiding and potentially preventing breaches of the broad statutorily-imposed requirements of the Dodd-Frank Act would go unmet.

Another alternative is for the MSRB to use a solely principles-based approach to its rulemaking on this subject. Under this approach, the regulatory objectives would be specified but individual firms would be free to select the means used to meet these objectives. Employing a solely principles-based approach, however, may provide insufficient guidance on meeting the standards of conduct for municipal advisors required under the Dodd-Frank Act and on establishing means for preventing breaches of applicable fiduciary duties. The MSRB believes that the duties and obligations articulated in the draft rule, although some are relatively more prescriptive, provide balanced and useful guidance. In addition, this balanced approach serves to minimize the risks attendant to the framework of municipal securities regulation involving multiple enforcement organizations.

[28] *See, e.g.*, *In re O'Brien Partners, Inc.*, Securities Act Release No. 7594, Investment Advisors Act Rel. No. 1772, A.P. File No. 3-9761 (Oct. 27, 1998), 1998 SEC LEXIS 2318, at 31 n.20 (citing *Production Credit Ass'n of Lancaster* v. *Croft*, 423 N.W. 2d 544, 547 (Wis. App. 1988); *Recorded Picture Co.* v. *Nelson Entertainment, Inc.*, 61 Cal. Rptr. 2d 742, 754 (Ct. App. 2 Dist. 1977)).

The MSRB invites public comment to suggest alternative regimes as well as comments on the potential costs and benefits of alternative regimes.

4. **Assessing the benefits and costs, both quantitative and qualitative, of the draft rule and the main alternative regulatory approaches.**

Below, the MSRB preliminarily addresses the likely costs and benefits of the draft rule against the context of the economic baselines discussed above, primarily in terms of the specific changes from the baseline and, to some degree, in terms of the potential overall impact on the market for municipal advisory services. In considering these costs, benefits and impacts, the MSRB addresses reasonable alternatives, where applicable.

At the outset, the MSRB notes it is currently unable to quantify the economic effects of draft Rule G-42 and the amendments to Rules G-8 and G-9 because the information necessary to provide reasonable estimates is not available. The MSRB observes, as the SEC also observed in its Final Rule, that there is little publicly available information about the municipal advisory industry. In addition, estimating the costs for municipal advisory firms to comply with the draft rule is hampered by the fact that these costs depend on the business activities and size of these municipal advisory firms, which can vary greatly. Given the limitations on the MSRB's ability to conduct a quantitative assessment of the costs and benefits associated with the draft rule, the MSRB has thus far considered these costs and benefits primarily in qualitative terms.

Benefits

The MSRB believes that the draft rule would result in a number of benefits by enhancing protections to municipal entities, obligated persons and investors and by providing guidance to municipal advisors for complying with the requirements of the Dodd-Frank Act.

The MSRB believes that one benefit of the draft rule is that it enhances protections to municipal entities and obligated persons by ensuring that these entities have available to them sufficient information to make meaningful choices about engaging a municipal advisor. These protections would also be enhanced as a result of the draft rule's guidance for municipal advisors that may assist these advisors in complying with, or help prevent breaches of, their fiduciary and fair-dealing duties. To the extent that this guidance increases the likelihood of compliance by municipal advisors, municipal entities and obligated persons will benefit. Investors in municipal bond offerings may benefit from the draft rule to the extent that a municipal

entity issuing bonds that uses a municipal advisor is more likely to receive services that reflect a higher ethical and professional standard than otherwise would be the case. Municipal entities, obligated persons and investors also may benefit to the extent that making explicit the core restrictions on certain activities in which the municipal advisor has a self-interest would reduce the incidence of self-dealing or other similar activities that can directly or indirectly raise costs of a financing that ultimately would be borne by municipal entities, obligated persons or investors.

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.

The MSRB believes that one benefit of the draft rule may follow from the increased level of information disclosed to clients by municipal advisors relative to the baseline, which may lead to an improvement in the selection of municipal advisors. As a result of the information disclosed through the draft rule, municipal entities and obligated persons may be able to more easily establish objective criteria to use in selecting municipal advisors and may increase the likelihood that municipal advisors are hired because of their qualifications as opposed to other reasons.

The draft rule should also result in improved quality-based competition among municipal advisors to the extent that the clients of municipal advisors rely on the information that would be required to be disclosed by the rule in the municipal advisor selection process.

Costs

In this section we preliminarily analyze the potential costs of the draft rule relative to the appropriate baseline. Our analysis does not consider all the costs associated with the draft rule, but instead focuses on the incremental costs attributable to the draft rule's requirements that exceed the baseline case. The costs associated with the baseline case are in effect subtracted from the costs associated with the draft rule in order to isolate the costs attributable to the incremental requirements of the draft rule.

The MSRB recognizes that municipal advisors would incur costs to meet the standards of conduct and duties contained in draft Rule G-42 and the amendments to Rules G-8 and G-9. These costs may include additional compliance costs and additional recordkeeping costs. To ensure compliance with the disclosure obligations of the draft rule, municipal advisors may incur costs by seeking advice from legal and compliance professionals when preparing disclosures to clients. However, the MSRB believes that some of these costs are accounted for in the baseline requirements of the SEC Final Rule which requires disclosure of at least some similar information, such as the disclosure of disciplinary history. Draft Rule G-42 may impose additional costs on municipal advisors as it requires disclosure of additional information and requires that information be disclosed directly to clients rather than through submissions to a regulator. The magnitude of these additional costs is not quantifiable using available data and the MSRB seeks public comment on this cost component.

Municipal advisors may incur additional recordkeeping costs as a result of the draft rule. The MSRB considers existing requirements in the SEC Final Rule on record-keeping and record preservation to serve as a baseline. As the SEC recognized in its economic analysis of its recordkeeping requirements, municipal advisors should already be maintaining books and records as part of their day-to-day operations. In addition, municipal advisors who are also registered as broker-dealers or investment advisors are currently subject to the recordkeeping requirements of those regulatory frameworks. Against these baselines, the MSRB believes that the costs associated with the few additional recordkeeping requirements associated with draft Rule G-42 will not be very significant, but seeks public comment on the magnitude of these costs.

The MSRB believes that any increase in municipal advisory fees attributable to the additional costs of the draft rule compared with the baseline state will be, in the aggregate, minimal and that the cost per municipal advisory firm will be spread across the number of advisory engagements for each firm. The MSRB recognizes, however, that for smaller municipal advisors with fewer clients, the cost of compliance with the draft rule's standards of conduct and duties may represent a greater percentage of annual revenues, and thus, such advisors may be more likely to pass those costs along to their advisory clients.

The MSRB recognizes that, as a result of these costs, some municipal advisors may decide to exit the market, curtail their activities, consolidate with other firms, or pass the costs on to municipal entities and obligated persons in the form of higher fees. The MSRB believes, however, that municipal advisors

may exit the market for a number of reasons, including business reasons separate from reasons involving the costs associated with the draft rule. The MSRB believes that municipal advisors that have been subject to past disciplinary actions may decide to exit the market rather than disclose that information directly to clients, which could improve the quality of the market for municipal advisory services and, therefore, benefit municipal entities and obligated persons. The Board recognizes that some of the municipal advisors that may exit the market for financial reasons could be small municipal advisors and that such exit from the market may lead to a reduced pool of municipal advisors.

The MSRB has also considered the possibility that some compliance costs could be greater in the absence of the draft rule. By articulating the duties and obligations of municipal advisors and by prescribing means that will prevent breaches of these duties, the draft rule may reduce possible confusion and uncertainty about what is required in order to comply with the Dodd-Frank Act. Therefore, the draft rule may reduce certain costs of compliance that might have otherwise been incurred by allowing municipal advisors to more quickly and accurately determine compliance requirements.

Effect on Competition, Efficiency and Capital Formation

The MSRB considered that the costs associated with the draft rule relative to the baseline may lead some municipal advisors to consolidate with other municipal advisors. For example, some municipal advisors may determine to consolidate with other municipal advisors in order to benefit from economies of scale (*e.g.*, by leveraging existing compliance resources of a larger firm) rather than to incur separately the costs associated with the draft rule. The MSRB believes that the market for municipal advisory services is likely to remain competitive despite the potential exit of some municipal advisors, including small municipal advisors, consolidation of municipal advisors, or lack of new entrants into the market.

As noted above, the increased level of information disclosed by municipal advisors relative to the baseline may lead to an improved municipal advisor selection process which may increase the willingness of municipal entities and obligated persons to use municipal advisors. This, in turn, may contribute to a more efficient capital formation process as municipal entities and obligated persons may make different decisions about issuance relative to other financing options.

Request for Comment on Economic Analysis

In furtherance of the MSRB's policy on economic analysis, the MSRB requests public comment on the potential economic consequences which may result from the adoption of draft Rule G-42 and the draft amendments to Rules G-8 and G-9. Commenters are encouraged to provide supporting data, studies, or other information related to their views of the economic effects of the draft rule. In particular, the MSRB welcomes any information regarding the potential to quantify likely benefits and costs. In addition to comments on the potential economic consequences associated with the draft rule, the MSRB also requests comment to help identify the potential benefits and costs of the regulatory alternatives suggested by commenters. The MSRB also requests comment on the competitive or anticompetitive effects, as well as efficiency and capital formation effects, of the draft rule and draft amendments on any market participants.

The Dodd-Frank Act provides that MSRB rules may not impose a regulatory burden on small municipal advisors that is not necessary or appropriate in the public interest and for the protection of investors, municipal entities, and obligated persons provided that there is robust protection of investors against fraud. The MSRB is sensitive to the potential impact of the requirements contained in draft Rule G-42 on small municipal advisors. The MSRB understands that some small municipal advisors and solo practitioners, unlike larger municipal advisory firms, may not employ full-time compliance staff and that the cost of ensuring compliance with the requirements of the draft rule may be proportionally higher for these smaller firms. The MSRB, preliminarily, believes that the draft rule is consistent with the Dodd-Frank Act's provision with respect to burdens imposed on small municipal advisors. In order to minimize any significant burdens on small municipal advisors, however, the MSRB is particularly interested in receiving meaningful feedback regarding the potential economic impact of the draft rule and draft amendments on small municipal advisors. The MSRB will consider such feedback in light of the Dodd-Frank Act provision.

In addition to any issues raised by this analysis about which interested persons may wish to comment, the MSRB specifically requests that commenters address the following questions:

1) Do commenters agree or disagree that a need exists for the MSRB to articulate the duties of municipal advisors or to prescribe means of preventing breaches of a municipal advisor's fiduciary duty to its municipal entity clients? If so, do commenters agree or disagree that the draft rule addresses those needs?

2) The MSRB proposes to use the fiduciary duty already imposed on municipal advisors by the Dodd-Frank Act to serve as a baseline for evaluating the economic impact of the draft rule's articulation of standards of conduct and duties for municipal advisors when engaging in municipal advisory activities for municipal entity clients. Is this an appropriate baseline?

3) The MSRB proposes to use the fair-dealing requirements under MSRB Rule G-17 to serve as a baseline for evaluating the economic impact of the draft rule's articulation of standards of conduct and duties for municipal advisors when engaging in municipal advisory activities for obligated persons. Is this an appropriate baseline?

4) The MSRB proposes to use the Dodd-Frank Act's prohibition on municipal advisors from engaging in any fraudulent, deceptive, or manipulative act or practice in connection with advising a client to serve as a baseline for evaluating the economic impact of the draft rule's articulation of standards of conduct for municipal advisors (regardless of whether the client is a municipal entity or obligated person). Is this an appropriate baseline?

5) The MSRB proposes to use the existing requirements for dealers who act as financial advisors to issuers with respect to the issuance of municipal securities to serve as a baseline for evaluating the economic impact of the draft rule's articulation of standards of conduct and duties for this subset of municipal advisors. Is this an appropriate baseline?

6) The MSRB proposes to use the required disclosures in registration forms of certain disciplinary history and legal events contained in the SEC Final Rule to serve as a baseline for evaluating the economic impact of the draft rule's disclosure requirements. Is this an appropriate baseline?

7) The MSRB proposes to use the recordkeeping and record preservation requirements contained in the SEC Final Rule to serve as a baseline for evaluating the economic impact of the draft rule's recordkeeping and record preservation requirements. Is this an appropriate baseline?

8) In addition to the baselines proposed above, are there other relevant baselines that the MSRB should consider?

9) Please compare the costs and benefits of having disciplinary histories and legal events disclosed through registration forms versus disclosure directly to the client.

10) Are there lower-cost alternatives to requiring disclosure of the amount of professional liability coverage carried by the municipal advisor that would provide comparable benefits to clients of municipal advisors?

11) Would additional benefits accrue if the MSRB were to impose different or additional recordkeeping requirements and, if so, what would these requirements entail?

12) To the extent that draft Rule G-42 establishes new, or clarifies existing, standards of conduct and duties for municipal advisors, will this cause a change in the quality of advice offered by municipal advisors?

13) To the extent that draft Rule G-42 and the draft amendments to Rules G-8 and G-9 impose costs on municipal advisors, will these costs be passed on to municipal entities or obligated persons in the form of higher fees?

14) To the extent that the requirements of draft Rule G-42 enhance the oversight of municipal advisors, will this affect the willingness of market participants to use municipal advisors?

15) To the extent that the requirements of draft Rule G-42 enhance the oversight of municipal advisors, will this lead to different issuance costs and financing terms for issuers?

16) To the extent that the requirements of draft Rule G-42 lead to reduced issuance costs and better financing terms for issuers, will this improve capital formation?

17) Would the requirements of draft Rule G-42 assist municipal entities or obligated persons in making hiring decisions with respect to municipal advisors?

18) What are the initial and ongoing costs associated with making and preserving the additional records required by the draft amendments to Rules G-8 and G-9?

19) Are there additional costs or benefits to recordkeeping that the MSRB should consider? If so, please explain.

20) If the draft rule is adopted, what are the likely effects on competition, efficiency and capital formation?

21) How will the requirements of draft Rule G-42 affect potential municipal advisors' decisions with respect to entry into the market?

22) What training costs would the requirements of draft Rule G-42 cause at municipal advisory firms to ensure compliance?

23) Will draft Rule G-42 have benefits in terms of protecting municipal entities, obligated persons and investors?

24) Will the requirements of draft Rule G-42 impose any burden on small municipal advisors that is not necessary or appropriate?

25) Will the requirements of draft Rule G-42 create advantages for large municipal advisor firms relative to smaller municipal advisor firms?

January 9, 2014

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Text of Proposed Amendments[29]

Rule G-42: Duties of Non-Solicitor Municipal Advisors

(a) *Standards of Conduct.*

(i) A municipal advisor to an obligated person client shall, in the conduct of all municipal advisory activities for that client, be subject to a duty of care.

(ii) A municipal advisor to a municipal entity client shall, in the conduct of all municipal advisory activities for that client, be subject to a fiduciary duty that includes a duty of loyalty and a duty of care.

(b) *Disclosure of Conflicts of Interest and Other Information*. A municipal advisor must, at or prior to the inception of a municipal advisory relationship, provide the client with a document making full and fair disclosure of all material conflicts of interest, including disclosure of:

(i) any actual or potential conflicts of interest of which it is aware after reasonable inquiry that might impair its ability either to render unbiased and competent advice to or on behalf of the client or to fulfill its fiduciary duty to the client, as applicable;

(ii) any affiliate of the municipal advisor that provides any advice, service, or product to or on behalf of the client that is directly or indirectly related to the municipal advisory activities to be performed by the disclosing municipal advisor;

[29] Underlining indicates new language; strikethrough denotes deletions.

(iii) any payments made by the municipal advisor directly or indirectly to obtain or retain the client's municipal advisory business;

(iv) any payments received by the municipal advisor from third parties to enlist the municipal advisor's recommendation to the client of its services, any municipal securities transaction or any municipal financial product;

(v) any fee-splitting arrangements involving the municipal advisor and any provider of investments or services to the client;

(vi) any conflicts of interest that may arise from the use of the form of compensation under consideration or selected by the client for the municipal advisory activities to be performed;

(vii) any other engagements or relationships of the municipal advisor or any affiliate of the municipal advisor that might impair the advisor's ability either to render unbiased and competent advice to or on behalf of the client or to fulfill its fiduciary duty to the client, as applicable;

(viii) the amount and scope of coverage of professional liability insurance that the municipal advisor carries (*e.g.*, coverage for errors and omissions, improper judgments, or negligence), deductible amounts, and any material limitations on such coverage, or a statement that the advisor does not carry any such coverage; and

(ix) any legal or disciplinary event that is (a) material to the client's evaluation of the municipal advisor or the integrity of its management or advisory personnel; (b) disclosed by the municipal advisor on the most recent Form MA filed with the Commission; or (c) disclosed by the municipal advisor on the most recent Form MA-I filed with the Commission regarding any individual actually engaging in or reasonably expected to engage in municipal advisory activities in the course of the engagement. If a municipal advisor has disclosed a legal or disciplinary event on any form referenced in section (b) or (c) of this rule, the advisor must provide the client with a copy of the relevant sections of the form or forms.

If a municipal advisor concludes that it has no material conflicts of interest, the municipal advisor must provide written documentation to the client to that effect.

(c) *Documentation of Municipal Advisory Relationship*. A municipal advisor must evidence each of its municipal advisory relationships by a writing entered into prior to, upon or promptly after the inception of the municipal advisory relationship. The writing must be dated and include, at a minimum,

(i) the form and basis of direct or indirect compensation, if any, for the municipal advisory activities to be performed;

(ii) the reasonably expected amount of any such compensation (stated in dollars to the extent it can be quantified);

(iii) the information regarding conflicts of interest and other matters that is required to be disclosed by section (b) of this rule;

(iv) the scope of the municipal advisory activities to be performed and any limitations on the scope of the engagement;

(v) in the case of municipal advisory activities relating to a new issue or reoffering of municipal securities, the specific undertakings, if any, requested by the client to be performed by the municipal advisor with respect to the preparation and finalization of an official statement or similar disclosure document; and

(vi) the date, triggering event, or means for the termination of the municipal advisory relationship, or, if none, a statement that there is none.

During the term of the municipal advisory relationship, the writing must be promptly amended or supplemented to reflect any changes in or additions to the terms or information required by section (b) or this section (c), and the revised writing must be promptly delivered to the client, provided that this requirement applies with respect to subsection(c)(ii) of this rule only if the change in the amount of reasonably expected compensation is material. This amendment and supplementation requirement applies to any changes and additions that are discovered, or should have been discovered, based on the exercise of reasonable diligence by the municipal advisor.

(d) *Recommendations*. A municipal advisor must not recommend that its municipal entity or obligated person client enter into any municipal securities transaction or municipal financial product unless the advisor has a reasonable basis for believing, based on the information obtained through the reasonable diligence of the advisor, that the transaction or product is suitable for the client. In addition, the municipal advisor must discuss with its client:

(i) the municipal advisor's evaluation of 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 municipal advisor reasonably believes that the recommended municipal securities transaction or municipal financial product is 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.

With respect to a client that is a municipal entity, a municipal advisor may only recommend a municipal securities transaction or municipal financial product that is in the client's best interest.

(e) *Review of Recommendations of Other Parties.* When requested to do so by its municipal entity or obligated person client and within the scope of its engagement, a municipal advisor must undertake a thorough review of any recommendation made by any third party regarding a municipal securities transaction or municipal financial product. In addition, the municipal advisor must discuss with its client:

(i) the municipal advisor's evaluation of the material risks, potential benefits, structure, and other characteristics of the recommended municipal securities transaction or municipal financial product;

(ii) whether the municipal advisor reasonably believes that the recommended municipal securities transaction or municipal financial product is suitable for the client, and the basis for such belief; 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.

(f) *Principal Transactions.* Except for an activity that is expressly permitted under Rule G-23, a municipal advisor, and any affiliate of a municipal advisor, is prohibited from engaging in any transaction, in a principal capacity, to which a municipal entity or obligated person client of the municipal advisor is a counterparty.

(g) *Specified Prohibitions.* A municipal advisor is prohibited from:

(i) receiving compensation that is excessive in relation to the municipal advisory activities actually performed;

(ii) delivering an invoice for fees or expenses for municipal advisory activities that do not accurately reflect the activities actually performed or the personnel that actually performed those services;

(iii) making any representation or the submission of any information about the capacity, resources or knowledge of the municipal advisor, in response to requests for proposals or qualifications or in oral presentations to a client or prospective client, for the purpose of obtaining or retaining municipal advisory business that the advisor knows or should know is materially false or misleading;

(iv) making, or participating in, any fee-splitting arrangements with underwriters, and any undisclosed fee-splitting arrangements with providers of investments or services to a municipal entity or obligated person client of the municipal advisor; and

(v) making payments for the purpose of obtaining or retaining municipal advisory business other than reasonable fees paid to another municipal advisor registered as such with the Commission and the Board for a solicitation of a municipal entity or obligated person as described in Section 15B(e)(9) of the Act.

(h) *Definitions*.

(i) "Advice" shall, for purposes of this rule, have the same meaning as in Section 15B(e)(4)(A)(i) of the Act and the rules and regulations thereunder.

(ii) "Affiliate of the municipal advisor" shall mean, for purposes of this rule, any person directly or indirectly controlling, controlled by, or under common control with such municipal advisor.

(iii) "Municipal advisor" shall, for purposes of this rule, have the same meaning as in Section 15B(e)(4) of the Act and the rules and regulations thereunder; provided that it shall exclude a person that is otherwise a municipal advisor solely with respect to either activities within the meaning of Section 15B(e)(4)(A)(ii) or any solicitation of a municipal entity or obligated person within the meaning of Section 15B(e)(9) of the Act.

(iv) "Municipal advisory activities" shall, for purposes of this rule, have the same meaning as the activities specified in Section 15B(e)(4)(A) of the Act and the rules and regulations thereunder, provided that they shall exclude the activities within the meaning of Section 15B(e)(4)(A)(ii) of the Act and the rules and regulations thereunder and any solicitation of a municipal entity or obligated person within the meaning of Section 15B(e)(9) of the Act and the rules and regulations thereunder.

(v) A "municipal advisory relationship" shall, for purposes of this rule, be deemed to exist when a municipal advisor engages in or enters into an agreement to engage in municipal advisory activities for a municipal entity or obligated person client.

(vi) "Municipal advisory business" shall mean, for purposes of this rule, the provision of advice to or on behalf of a municipal entity or an obligated person with respect to the issuance of municipal securities or municipal financial products by a municipal advisor whether for compensation or otherwise.

(vii) "Municipal entity" shall, for purposes of this rule, have the same meaning as in Section 15B(e)(8) of the Act and the rules and regulations thereunder.

(viii) "Obligated person" shall, for purposes of this rule, have the same meaning as in Section 15B(e)(10) of the Act and the rules and regulations thereunder.

(ix) "Official statement" shall, for purposes of this rule, have the same meaning as in Rule G-32(d)(vii).

---Supplementary Material:

.01 Duty of Care. Municipal advisors must exercise due care in performing their municipal advisory activities. The duty of care includes, but is not limited to, the obligations discussed in this section. A municipal advisor must possess the degree of knowledge and expertise needed to provide the municipal entity or obligated person client with informed advice. A municipal advisor also must make a reasonable inquiry as to the facts that are relevant to a client's determination as to whether to proceed with a course of action or that form the basis for any advice provided to the client. A municipal advisor that is engaged by a client in connection with either an issuance of municipal securities or a municipal financial product that is related to an issuance of municipal securities must also undertake a thorough review of the official statement for that issue, unless otherwise directed by the client and documented under subsection (c)(iv) of this rule. A municipal advisor must undertake a reasonable investigation to determine that it is not

basing any recommendation on materially inaccurate or incomplete information. Among other matters, a municipal advisor must have a reasonable basis for:

(a) any advice provided to or on behalf of a client;

(b) any representations made in a certificate that it 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; and

(c) any information provided to the client or other parties involved in the municipal securities transaction when participating in the preparation of an official statement for any issue of municipal securities with respect to which the advisor is advising.

.02 Duty of Loyalty. Municipal advisors must fulfill a duty of loyalty in performing their municipal advisory activities for municipal entity clients. The duty of loyalty includes, but is not limited to, the obligations discussed in this section. A municipal advisor must deal honestly and with the utmost good faith with a municipal entity client and act in the client's best interests without regard to the financial or other interests of the municipal advisor. A municipal advisor to a municipal entity client must either eliminate or provide full and fair disclosure to the client about each of its material conflicts of interest. A municipal advisor must investigate or consider other reasonably feasible alternatives to any recommended municipal securities transaction or municipal financial product that might also or alternatively serve the municipal entity client's objectives.

.03 Action Independent of or Contrary to Advice. If a municipal entity or obligated person client of a municipal advisor elects a course of action that is independent of or contrary to advice provided by the advisor, the advisor is not required on that basis to disengage from the municipal advisory relationship.

.04 Limitations on the Scope of the Engagement. Nothing contained in this rule shall be construed to permit the municipal advisor to alter the standards of conduct or impose limitations on any of the duties prescribed herein. If requested or consented to by the municipal entity or obligated person client, however, a municipal advisor may limit the scope of the municipal advisory relationship to certain specified activities or services. If the municipal advisor engages in a course of conduct that is inconsistent with any such agreed upon limitations, it may result in negating the effectiveness of such limitations.

.05 Conflicts of Interest. Disclosures of conflicts of interest by a municipal advisor to its municipal entity or obligated person client must be sufficiently detailed to inform the client of the nature, implications and potential consequences of each conflict. Such disclosures also must include an explanation of how the advisor addresses or intends to manage or mitigate each conflict.

.06 Applicability of State or Other Laws. 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 the activities of municipal advisors.

.07 Disclosure to Investors. If all or a portion of a document prepared by a municipal advisor or any of its affiliates is included in an official statement for any issue of municipal securities by or on behalf of its municipal entity or obligated person client, the municipal advisor must provide written disclosure to investors, which disclosure may be provided in the official statement, of any affiliation that meets the criteria of subsection (b)(ii) of this rule. This disclosure requirement shall be deemed satisfied if the relevant affiliate provides the required written disclosure to investors.

.08 Suitability. A determination of whether a municipal securities transaction or municipal financial product is suitable must be based on the client's financial situation and needs, objectives, tax status, risk tolerance, liquidity needs, experience with municipal securities transactions or municipal financial products generally or of the type and complexity being recommended, 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 in the municipal securities transaction are reasonably expected to be outstanding and any other material information known by the municipal advisor about the client and the municipal securities transaction or municipal financial product, after reasonable inquiry.

.09 Know Your Client. A municipal advisor must use reasonable diligence, in regard to the maintenance of the municipal advisory relationship, to know and retain the essential facts concerning the client and concerning the authority of each person acting on behalf of such client. The facts "essential" to "knowing a client" include those required to:

(a) effectively service the municipal advisory relationship with the client;

(b) act in accordance with any special directions from the client;

(c) understand the authority of each person acting on behalf of the client; and

(d) comply with applicable laws, regulations and rules.

.10 529 College Savings Plans and Other Municipal Fund Securities. This rule applies equally to municipal advisors to sponsors or trustees of 529 college savings plans and other municipal fund securities. All references in this rule to an "official statement" include the plan disclosure document for a 529 college savings plan and the investment circular or information statement for a local government investment pool.

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Rule G-8: Books and Records to be Made by Brokers, Dealers, ~~and~~ Municipal Securities Dealers, and Municipal Advisors

(a) - (g) No change.

(h) *Municipal Advisor Records*. Every municipal advisor that is registered or required to be registered under section 15B of the Act and the rules and regulations thereunder shall make and keep current the following books and records:

(i) *General Business Records.* All books and records described in Rule 15Ba1-8(a)(1)-(8) under the Act.

(ii) *Records Concerning Duties of Non-Solicitor Municipal Advisors pursuant to Rule G-42.*

(A) A copy of any document created by a municipal advisor that was material to its review of a recommendation by another party or that memorializes the basis for any conclusions as to suitability; and

(B) Unless included in the official statement for an issue of municipal securities, a copy of any disclosure provided by the municipal advisor or any affiliate of the municipal advisor to investors, as required by the provisions of Rule G-42 Supplementary Material .07.

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Rule G-9: Preservation of Records

(a) - (d) No change.

(e) *Method of Record Retention.* Whenever a record is required to be preserved by this rule, such record may be retained either as an original or as a copy or other reproduction thereof, or on microfilm, ~~electronic or~~ magnetic tape, electronic storage media, or by the other similar medium of record retention, provided that such broker, dealer, ~~or~~ municipal securities dealer, or municipal advisor shall have available adequate facilities for ready retrieval and inspection of any such record and for production of easily readable facsimile copies thereof and, in the case of records retained on microfilm, ~~electronic or~~ magnetic tape, electronic storage media, or other similar medium of record retention, duplicates of such records shall be stored separately from each other for the periods of time required by this rule.

(f) *Effect of Lapse of Registration.* The requirements of this rule shall continue to apply, for the periods of time specified, to any broker, dealer, ~~or~~ municipal securities dealer, or municipal advisor which ceases to be registered with the Commission, except in the event a successor registrant shall undertake to maintain and preserve the books and records described herein for the required periods of time.

(g) No change.

(h) *Municipal Advisor Records*. Every municipal advisor shall preserve the books and records described in Rule G-8(h) for a period of not less than five years.

(i) *Municipal Advisor Records Related to Formation and Cessation of its Business*. Every municipal advisor shall comply with the provisions of Rule 15Ba1-8(b)(2) and (c) under the Act.

(j) *Records of Non-Resident Municipal Advisors.* Every non-resident municipal advisor shall comply with the provisions of Rule 15Ba1-8(f) under the Act.

(k) *Electronic Storage of Municipal Advisor Records Permitted.* Whenever a record is required to be preserved by this rule by a municipal advisor, such record may be preserved on electronic storage media in accordance with section (e). Electronic preservation of any record in a manner that complies with Rule 15a1-8(d) under the Act will be deemed to be in compliance with the requirements of this rule.