Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS AUGUST 1, 2012

Rule G-17 Guidance on Underwriter Responsibilities Becomes Effective August 2, 2012

The Municipal Securities Rulemaking Board's Interpretative Guidance on Underwriter Fair Dealing Obligations contained in Notice 2012-25 (the "Notice," available at www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2012/2012-25.aspx) will become effective for bonds sold on or after August 2, 2012. The Notice imposes expansive code of conduct and disclosure requirements on underwriters of municipal securities under the "fair dealing" provisions of MSRB Rule G-17, which provides in pertinent part:

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

The MSRB published implementation guidance on July 18, 2012 (the "Guidance," available at www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2012/2012-38.aspx) to assist dealers in revising their written supervisory procedures to ensure full compliance with the Notice, as well as to clarify certain provisions of the Notice. This Client Alert summarizes both the Notice and the Guidance.

Scope and Applicability of G-17 Guidance

While the Notice and the Guidance apply to all underwritings and private placements, they focus on negotiated underwritings with a narrower application to competitive underwritings. Limited exceptions are made for private placements effected by a municipal advisor not acting as a principal.

The Guidance spells out underwriter duties to state and local government bond issuers, and does not apply directly to underwriter duties to other parties, including conduit borrowers, but the Guidance "may serve as one of many bases for . . . appropriate policies and procedures" that ensure an underwriter's compliance with its fair dealing obligations to all persons.

Governing Principles

The Guidance provides 10 governing principles (the "Principles") for an underwriter's compliance with its Rule G-17 obligations. The Guidance separates the Principles interpreting the "fair dealing" standard into three categories: (i) rules governing statements and representations to issuers, (ii) rules relating to fairness of underwriting and (iii) required disclosures to issuers.

Statements and Representations to Issuers

The Notice requires that an underwriter disclose to the issuer all material aspects of the financing structure to be used in a transaction, taking into account the complexity of the transaction and the experience and knowledge of the issuer.

Statement of Principle #1 provides that:

> "An underwriter must not misrepresent or omit the facts, risks, potential benefits, or other material information about municipal securities activities undertaken with a municipal issuer."

Representations (written or oral) made to an issuer must be truthful and accurate, must not misrepresent or omit material facts, and must be made on a reasonable basis. The requirements apply to all aspects of issuer dealings, from inception to closing, even those communications that

are incidental to the transaction, including RFP responses, cash flow models and closing certificates.

Statement of Principle #2, which is more appropriately understood as a proscription rather than as a principle, provides that:

> "An underwriter in a negotiated underwriting must not recommend that the issuer not retain a municipal advisor."

Fairness of Financial Aspects of an Underwriting

Collectively, Principles #3 through #6 address the main aspects to be considered in establishing fair dealing in connection with the financial aspects of a transaction.

Statement of Principle #3 provides:

> "An underwriter must not charge or otherwise collect, as compensation for a new issue (including both direct compensation paid by the issuer and other separate payments, values, or credits received by the underwriter from the issuer or any other party in connection with the underwriting), amounts that are, in light of the specific facts and circumstances of the offering, so disproportionate to the nature of the underwriting and related services performed as to constitute an unfair practice to the issuer."

Compensation is evaluated in light of credit quality, issue size, market conditions, amount of structuring work and costs paid by underwriter.

Statement of Principle #4 requires:

> "The price an underwriter pays to an issuer in a primary offering must be fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value of the issue at the time it is priced."

A bona fide bid in a competitive sale is deemed to meet this requirement. Otherwise, for negotiated underwritings, the underwriter must provide accurate statements and representations regarding aspects of pricing, investor demand and sales efforts.

Statement of Principle #5 addresses arrangements between the underwriter and an investor:

> "Arrangements between the underwriter and an investor purchasing new issue securities from the underwriter according to which profits realized from the resale by such investor of the securities are directly or indirectly split or otherwise shared with the underwriter also would, depending on the facts and circumstances (including in particular if such resale occurs reasonably close in time to the original sale by the underwriter to the investor), constitute a violation of the underwriter's fair dealing obligation under Rule G-17."

Arrangements between the underwriter and the investor are not necessarily limited to written arrangements, and can be implied or inferred from the course of conduct and pattern of dealing between the underwriter and the investor. Such an arrangement would also be a required disclosure under the conflicts of interest rules.

Statement of Principle #6 prohibits the characterization of certain expenses for the personal benefit of issuer personnel as a cost of issuance:

> "An underwriter must not characterize excessive or lavish expenses for the personal benefit of issuer personnel as an expense of the issue for which it seeks reimbursement from bond proceeds or the issuer"

Such characterization may also violate the prohibition on gifts and gratuities to an issuer under Rule G-20.

Required Disclosures

The Notice included the following list of required disclosures to issuers:

- G-17 fair dealing obligation
- Underwriter is entering into an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer
- Underwriter does not have a fiduciary duty to the issuer and is not required by federal securities law to act in the best interests of the issuer
- Underwriter is obligated to purchase and sell securities at fair and reasonable prices
- Underwriter will review official statements consistent with its obligations under federal securities law
- Contingent compensation causes a conflict of interest

Statement of Principle #7 addresses role-based disclosures:

> "In a negotiated underwriting, the underwriter must disclose to the issuer specific information regarding its role in an issuance of municipal securities."

Echoing the required disclosures from the Notice, the Guidance goes on to state that the underwriter must disclose that Rule G-17 requires an underwriter to deal fairly at all times with both municipal issuers and investors, that the underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and that it has financial and other interests that differ from those of the issuer.

Further, the Guidance requires that the underwriter disclose that unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer and is not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests. The underwriter must also disclose that it has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable. Finally, the underwriter must disclose that it will review the official statement for the issuer's securities in accordance with, and as part of, its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction.

Statement of Principle #8 address conflicts of interest:

> "In a negotiated underwriting, the underwriter must disclose to the issuer its actual or potential material conflicts of interest with respect to such issuance – that is, the requirement to provide such disclosure is triggered only if:
>
> – the new issue is sold in a negotiated underwriting;
> – the matter to be disclosed represents a conflict of interest, either in reality or potentially; and
> – any such actual or potential conflict of interest is material."

Such required conflicts disclosure would include (among other things) profit-sharing arrangements with investors, dealings in credit default swaps with reference to the issuer, incentives to recommend complex municipal securities transaction and related conflicts of interest.

Statement of Principle #9 further addresses disclosure for a complex municipal securities financing:

> "An underwriter in a negotiated offering that recommends a complex municipal securities financing to an issuer must disclose the material financial characteristics of the complex municipal securities financing, as well as the material financial risks of the financing that are known to the underwriter and reasonably foreseeable at the time of the disclosure – that is, the requirement to provide such disclosure is triggered if:
>
> – the new issue is sold in a negotiated underwriting;
> – the new issue is a complex municipal securities financing; and
> – such financing was recommended by the underwriter."

A complex municipal securities financing may consist of an otherwise routine financing structure that incorporates a unique, atypical or complex element. A transaction involving variable rate demand obligations, derivatives, or index-based interest rates will be deemed to be a complex municipal securities financing.

However, the Guidance provides that "[u]nderwriters must make reasonable judgments regarding whether a particular recommended financing structure or product is complex, understanding that the simple fact that a structure or product has become relatively common in the market does not automatically result in it being viewed as not complex."

Further, the Guidance states that the level of disclosure required may vary according to the issuer's knowledge or experience with the proposed financing structure or similar structures, its capability of evaluating the risks of the recommended financing, and its financial ability to bear the risks of the recommended financing, in each case based on the reasonable belief of the underwriter. An underwriter cannot satisfy this requirement by providing an issuer with a single document setting out general descriptions of the various complex municipal securities financing structures or products it may recommend from time to time to its various issuer clients that would effectively require issuer personnel to discover which disclosures apply to a particular recommendation and to the particular circumstances of that issuer.

Statement of Principle #10, addresses when certain disclosures must be made to the issuer:

> "If the underwriter reasonably believes that issuer personnel responsible for the issuance of municipal securities lack knowledge or experience with a financing structure, even if such structure is routine and well understood by the typical municipal market professional, the underwriter must provide disclosures on the material aspects of such structures that it recommends."

Such disclosures must be made in writing to a responsible issuer official in a clear manner by each underwriter that has a conflict of interest, or by the syndicate manager in all other cases.

Timing on Disclosures in Routine Financings

The acknowledgement of the issuer of the required disclosures should be sought, or, at a minimum, reasonable efforts to obtain such acknowledgment should be made. Rule G-23 disclosures on the underwriter's role must be made at the inception of the transaction. While municipal securities firms are free to establish their own protocols and procedures, it is expected that the required Rule G-17 disclosures will be included in engagement letters and, in any event, must be made sufficiently in advance of sale. However, the need for additional disclosures may arise during the course of a transaction, and must be made promptly when the need arises.

The Securities Industry and Financial Markets Association and the Bond Dealers of America have each published suggested forms of the disclosures required by the Notice and the Guidance. Most municipal securities firms appear to be incorporating these disclosures into their standard forms of engagement letters and disclosure materials.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact any attorney in Chapman's Public Finance Department or visit us online at chapman.com.

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