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Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing of a Proposed Rule Change Consisting of Proposed New Rule G–42, on Duties of Non-Solicitor Municipal Advisors, and Proposed Amendments to Rule G–8, on Books and Records To Be Made by Brokers, Dealers, Municipal Securities Dealers, and Municipal Advisors; Notice

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–74860; File No. SR–MSRB–2015–03]

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing of a Proposed Rule Change Consisting of Proposed New Rule G–42, on Duties of Non-Solicitor Municipal Advisors, and Proposed Amendments to Rule G–8, on Books and Records To Be Made by Brokers, Dealers, Municipal Securities Dealers, and Municipal Advisors

May 4, 2015.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Act'') [1] and Rule 19b–4 thereunder,[2] notice is hereby given that on April 24, 2015, the Municipal Securities Rulemaking Board (the ''MSRB'' or ''Board'') filed with the Securities and Exchange Commission (the ''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the MSRB. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The MSRB filed with the Commission a proposed rule change consisting of proposed new Rule G–42, on duties of non-solicitor municipal advisors, and proposed amendments to Rule G–8, on books and records to be made by brokers, dealers, municipal securities dealers, and municipal advisors (the ''proposed rule change''). The MSRB requests that the proposed rule change be approved with an implementation date six months after the Commission approval date for all changes.

The text of the proposed rule change is available on the MSRB's Web site at *www.msrb.org/Rules-and-Interpretations/SEC-Filings/2015-Filings.aspx*, at the MSRB's principal office, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the MSRB included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The MSRB has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Following the financial crisis of 2008, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act'').[3] The Dodd-Frank Act establishes a new federal regulatory regime requiring municipal advisors to register with the SEC, deeming them to owe a fiduciary duty to their municipal entity clients and granting the MSRB rulemaking authority over them. The MSRB, in the exercise of that authority, is currently developing a comprehensive regulatory framework for municipal advisors. A significant element of that regulatory framework is Proposed Rule G–42, which would establish core standards of conduct for municipal advisors that engage in municipal advisory activities, other than municipal advisory solicitation activities (hereinafter, ''municipal advisors'').[4] Proposed Rule G–42 is accompanied by associated proposed amendments to Rule G–8.

Proposed Rule G–42

Proposed Rule G–42 would establish the core standards of conduct and duties of municipal advisors when engaging in municipal advisory activities. The proposed rule draws on aspects of existing law and regulation under other relevant regulatory regimes, including those applicable to brokers, dealers and municipal securities dealers under MSRB rules and the Exchange Act, investment advisers under the Investment Advisers Act of 1940 [5] (''Investment Advisers Act'') and commodity trading advisors under the Commodity Exchange Act (''CEA'').[6]

In summary, the core provisions of Proposed Rule G–42 would:

- Establish certain standards of conduct consistent with the fiduciary duty owed by a municipal advisor to its municipal entity clients, which includes, without limitation, a duty of care and of loyalty;
- Establish the standard of care owed by a municipal advisor to its obligated person clients;
- Require the full and fair disclosure, in writing, of all material conflicts of interest and legal or disciplinary events that are material to a client's evaluation of a municipal advisor;
- Require the documentation of the municipal advisory relationship, specifying certain aspects of the relationship that must be included in the documentation;
- Require that recommendations made by a municipal advisor are suitable for its clients, or determine the suitability of recommendations made by third parties when appropriate; and
- Specifically prohibit a municipal advisor from engaging in certain activities, including, in summary:
  - Receiving excessive compensation;
  - delivering inaccurate invoices for fees or expenses;
  - making false or misleading representations about the municipal advisor's resources, capacity or knowledge;
  - participating in certain fee-splitting arrangements with underwriters;
  - participating in any undisclosed fee-splitting arrangements with providers of investments or services to a municipal entity or obligated person client of the municipal advisor;
  - making payments for the purpose of obtaining or retaining an engagement to perform municipal advisory activities, with limited exceptions; and
  - entering into certain principal transactions with the municipal advisor's municipal entity clients.

In addition, the proposed rule change would define key terms used in Proposed Rule G–42 and provide supplementary material. The supplementary material would provide additional guidance on the core concepts in the proposed rule, such as the duty of care, the duty of loyalty, suitability of recommendations and ''Know Your Client'' obligations; provide context for issues such as the scope of an engagement, conflicts of interest disclosures, excessive compensation and the impact of client action that is independent of or contrary to the advice of a municipal advisor, and the applicability of the proposed rule change to 529 college savings plans (''529 plans'') and other municipal

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Public Law No. 111–203, 124 Stat. 1376 (2010).

[4] *See* Registration of Municipal Advisors, Rel. No. 34–70462 (Sept. 20, 2013), 78 FR 67467, at 67519, note 679 (Nov. 12, 2013) (''SEC Final Rule'') (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''). The proposed rule change would not apply to municipal advisors when engaging in the solicitation of a municipal entity or obligated person within the meaning of Exchange Act Section 15B(e)(9) (15 U.S.C. 78*o*-4(e)(9)).

[5] 15 U.S.C. 80b–1 *et seq.*

[6] 7 U.S.C. 1 *et seq.*

entities; provide guidance regarding the definition of ''engage in a principal transaction;'' the continued applicability of state and other laws regarding fiduciary and other duties owed by municipal advisors; and, finally, include information regarding requirements that must be met for a municipal advisor to be relieved of certain provisions of Proposed Rule G–42 in instances when it inadvertently engages in municipal advisory activities.

Standards of Conduct

Section (a) of Proposed Rule G–42 would establish the core standards of conduct and duties applicable to municipal advisors. The approach toward the core standards and duties in Proposed 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 and those duties owed to clients that are obligated persons. The Dodd-Frank Act specifically deems a municipal advisor to owe a fiduciary duty to its municipal entity clients.[7] In contrast, the Dodd-Frank Act does not impose a fiduciary duty with respect to a municipal advisor's obligated person clients.[8]

Subsection (a)(i) of Proposed Rule G–42 would provide that each municipal advisor in the conduct of its municipal advisory activities for an obligated person client is subject to a duty of care. Subsection (a)(ii) would provide that each municipal advisor in the conduct of its municipal advisory activities for a municipal entity client is subject to a fiduciary duty, which includes, without limitation, a duty of loyalty and a duty of care. The standards contained in these subsections would not supersede any more restrictive provisions of state or other laws applicable to the activities of municipal advisors.

Proposed supplementary material would provide guidance on the duty of care and the duty of loyalty. Generally, in lieu of providing detailed requirements, the duties would be described in terms that would empower the client to, in large part, determine the scope of services and control the engagement with the municipal advisor (with the municipal advisor's agreement).

Paragraph .01 of the Supplementary Material would describe the duty of care to require, without limitation, a municipal advisor to: (1) Exercise due care in performing its municipal advisory activities; (2) possess the degree of knowledge and expertise needed to provide the municipal entity or obligated person client with informed advice; (3) 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 (4) undertake a reasonable investigation to determine that the municipal advisor is not basing any recommendation on materially inaccurate or incomplete information. The duty of care that would be established in section (a) of Proposed Rule G–42, would also require the municipal advisor to have a reasonable basis for: Any advice provided to or on behalf of a client;[9] 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, any information provided to the client or other parties involved in the municipal securities transaction in connection with the preparation of an official statement for any issue of municipal securities as to which the advisor is advising.

Paragraph .02 of the Supplementary Material would describe the duty of loyalty to require, without limitation, a municipal advisor, when engaging in municipal advisory activities for a municipal entity, to deal honestly and with the utmost good faith with the client and act in the client's best interests without regard to the financial or other interests of the municipal advisor. Paragraph .02 would also provide that the duty of loyalty would preclude a municipal advisor from engaging in municipal advisory activities with a municipal entity client if it cannot manage or mitigate its conflicts of interest in a manner that will permit it to act in the municipal entity's best interests.

Paragraph .03 of the Supplementary Material would specify that a municipal advisor is not required to disengage from a municipal advisory relationship if a municipal entity client or an obligated person client elects a course of action that is independent of or contrary to advice provided by the municipal advisor.

Paragraph .04 of the Supplementary Material would specify that a municipal advisor could limit the scope of the municipal advisory activities to be performed to certain specified activities or services if requested or expressly consented to by the client, but could not alter the standards of conduct or impose limitations on any of the duties prescribed by Proposed Rule G–42. Paragraph .04 would provide that, if a municipal advisor engages in a course of conduct that is inconsistent with the mutually agreed limitations to the scope of the engagement, it may result in negating the effectiveness of the limitations.

Paragraph .07 of the Supplementary Material would state, as a general matter, that, municipal advisors may be subject to fiduciary or other duties under state or other laws and nothing in Proposed Rule G–42 would supersede any more restrictive provision of state or other laws applicable to municipal advisory activities.

Disclosure of Conflicts of Interest and Other Information

Section (b) of Proposed Rule G–42 would require a municipal advisor to fully and fairly disclose to its client in writing all material conflicts of interest, and to do so prior to or upon engaging in municipal advisory activities. The provision would set forth a non-exhaustive list of scenarios under which a material conflict of interest would arise or be deemed to exist and that would require a municipal advisor to provide written disclosures to its client.

Paragraph (b)(i)(A) would require a municipal advisor to disclose any actual or potential conflicts of interest of which the municipal advisor becomes aware after reasonable inquiry that could reasonably be anticipated to impair the municipal advisor's ability to provide advice to or on behalf of the client in accordance with the applicable standards of conduct (*i.e.,* a duty of care or a fiduciary duty). Paragraphs (b)(i)(B) through (F) would provide more specific scenarios that give rise to conflicts of interest that would be deemed to be material and require proper disclosure to a municipal advisor's client. Under the proposed rule change, a material

[7] *See* Section 15B(c)(1) of the Exchange Act, 15 U.S.C. 78*o*–4(c)(1) which 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.

[8] *See* SEC Final Rule, 78 FR at 67475, note 100.

[9] The duty of care, which is applicable to all municipal advisory activities, would apply to the provision of comments following the review of any document and the provision of language for use in any document—including an official statement—to the extent that conduct constituted municipal advisory activity. Furthermore, such conduct would be required to comport with the fiduciary duty owed in the case of a municipal entity client.

conflict of interest would always include: any affiliate of the municipal advisor that provides any advice, service or product to or on behalf of the client that is directly related to the municipal advisory activities to be performed by the disclosing municipal advisor; any payments made by the municipal advisor, directly or indirectly, to obtain or retain an engagement to perform municipal advisory activities for the client; any payments received by the municipal advisor from a third party to enlist the municipal advisor's recommendations to the client of its services, any municipal securities transaction or any municipal financial product; any fee-splitting arrangements involving the municipal advisor and any provider of investments or services to the client; and any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice. Paragraph (b)(i)(G) would require municipal advisors to disclose any other engagements or relationships of the municipal advisor that could reasonably be anticipated to impair its ability to provide advice to or on behalf of its client in accordance with the applicable standards of conduct established by section (a) of the proposed rule.

Under subsection (b)(i), if a municipal advisor were to conclude, based on the exercise of reasonable diligence, that it had no known material conflicts of interest, the municipal advisor would be required to provide a written statement to the client to that effect.

Subsection (b)(ii) would require disclosure of any legal or disciplinary event that would be material to the client's evaluation of the municipal advisor or the integrity of its management or advisory personnel. To facilitate the use of existing records, a municipal advisor would be permitted to fulfill this disclosure obligation by identifying the specific type of event and specifically referring the client to the relevant portions of the municipal advisor's most recent SEC Forms MA or MA–I [10] filed with the Commission, if the municipal advisor provides detailed information specifying where the client could access such forms electronically. The requirement to specifically refer to the relevant portions of the forms would not be satisfied by a broad reference to the section of the forms containing such disclosures. Similarly, the specific-information requirement for access to the forms would not be satisfied by a general reference to the SEC's Electronic Data Gathering, Analysis, and Retrieval system (''EDGAR''). A municipal advisor could alternatively meet this latter requirement, for example, by publishing its most recent forms on its own Web site and then providing the client with the direct web link or internet address.

Paragraph .05 of the Supplementary Material would provide that the required conflicts of interest disclosures must be sufficiently detailed to inform the client of the nature, implications and potential consequences of each conflict and must include an explanation of how the municipal advisor addresses or intends to manage or mitigate each conflict.[11] Coupled with its duty to disclose material conflicts of interest, a municipal advisor's obligation to explain how it addresses or intends to manage or mitigate its material conflicts of interest was included in the proposed rule to reflect the Board's intent to eliminate, or at least to expose and reduce the occurrence of, material conflicts of interest that might incline a municipal adviser to provide advice or a recommendation which was not disinterested.[12] If not properly managed or mitigated, material conflicts of interest could lead to a failure to protect a municipal advisor's client's interest, thereby causing a breach of the duty of care and/or loyalty that would be established by proposed section (a).

Paragraph .06 of the Supplementary Material would provide that a municipal advisor that inadvertently engages in municipal advisory activities but does not intend to continue the municipal advisory activities or enter into a municipal advisory relationship [13] would not be required to comply with sections (b) and (c) of Proposed Rule G–42 (relating to disclosure of conflicts of interest and documentation of the relationship), if the municipal advisor takes the prescribed actions listed under paragraph .06 promptly after it discovers its provision of inadvertent advice. The municipal advisor would be required to provide to the client a dated document that would include: a disclaimer stating that the municipal advisor did not intend to provide advice and that, effective immediately, the municipal advisor has ceased engaging in municipal advisory activities with respect to that client in regard to all transactions and municipal financial products as to which advice was inadvertently provided; a notification that the client should be aware that the municipal advisor has not provided the disclosure of material conflicts of interest and other information required under section (b); an identification of all of the advice that was inadvertently provided, based on a reasonable investigation; and a request that the municipal entity or obligated person acknowledge receipt of the document. The municipal advisor also would be required to conduct a review of its supervisory and compliance policies and procedures to ensure that they are reasonably designed to prevent inadvertently providing advice to municipal entities and obligated persons. The final sentence of paragraph .06 of the Supplementary Material would also clarify that the satisfaction of the requirements of paragraph .06 would have no effect on the applicability of any provisions of Proposed Rule G–42 other than sections (b) and (c), or any other legal requirements applicable to municipal advisory activities. Such other legal requirements, would include, but would not be limited to, other MSRB rules (including Rule G–23), Financial Industry Regulatory Authority (''FINRA'') rules or federal or state laws that apply to municipal advisory activities.[14]

[10] *See* 17 CFR 249.1300 (SEC Form MA); 17 CFR 249.1310 (SEC Form MA–I).

[11] This requirement is analogous to the requirement of Form ADV (17 CFR 279.1) under the Investment Advisers Act (15 U.S.C. 80b–1 *et seq.*) that obligates an investment adviser to describe how it addresses certain conflicts of interest with its clients. *See, e.g.,* Form ADV, Part 2, Item 5.E.1 of Part 2A (requiring an investment adviser to describe how it will address conflicts of interest that arise in regards to fees and compensation it receives, including the investment adviser's procedures for disclosing the conflicts of interest with its client). *See also,* Form ADV, Part 2A Items 6, 10, 11, 14 and 17.

[12] *See, e.g., SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 191–92 (1963).

[13] Under subsection (f)(vi) of Proposed Rule G–42, a municipal advisory relationship would be deemed to exist when a municipal advisor enters into an agreement to engage in municipal advisory activities for a municipal entity or obligated person, and would be deemed to have ended on the earlier of (i) the date on which the municipal advisory relationship has terminated pursuant to the terms of the documentation of the municipal advisory relationship required in section (c) of Proposed Rule G–42 or (ii) the date on which the municipal advisor withdraws from the municipal advisory relationship.

[14] Rule G–23, on activities of financial advisors, generally provides that a dealer that has a financial advisory relationship (as defined by Rule G–23(b)) with respect to the issuance of municipal securities is precluded from acquiring all or any portion of such issue, directly or indirectly, from the issuer as principal, either alone or as a participant in a syndicate or other similar account formed for that purpose. A dealer is also, under Rule G–23, precluded from arranging the placement of an issue with respect to which it has a financial advisory relationship.

Documentation of the Municipal Advisory Relationship

Section (c) of Proposed Rule G–42 would require each municipal advisor to evidence each of its municipal advisory relationships by a writing, or writings created and delivered to the municipal entity or obligated person client prior to, upon or promptly after the establishment of the municipal advisory relationship. The documentation would be required to be dated and include, at a minimum: [15]

- the form and basis of direct or indirect compensation, if any, for the municipal advisory activities to be performed, as provided in proposed subsection (c)(i);
- the information required to be disclosed in proposed section (b), including the disclosures of conflicts of interest, as provided in proposed subsection (c)(ii);
- a description of the specific type of information regarding legal and disciplinary events requested by the Commission on SEC Form MA and SEC Form MA–I, as provided in proposed subsection (c)(iii), and detailed information specifying where the client may electronically access the municipal advisor's most recent Form MA and each most recent Form MA–I filed with the Commission; [16]
- the date of the last material change to the legal or disciplinary event disclosures on any SEC Forms MA or MA–I filed with the Commission by the municipal advisor, as provided in proposed subsection (c)(iv);
- the scope of the municipal advisory activities to be performed and any limitations on the scope of the engagement, as provided in proposed subsection (c)(v);
- the date, triggering event, or means for the termination of the municipal advisory relationship, or, if none, a statement that there is none, as provided in proposed subsection (c)(vi); and
- any terms relating to withdrawal from the municipal advisory relationship, as provided in proposed subsection (c)(vii).

Proposed Rule G–42(c) also would require municipal advisors to promptly amend or supplement the writing(s) during the term of the municipal advisory relationship as necessary to reflect any material changes or additions in the required information. For example, if the basis of compensation or scope of services materially changed during the term of the relationship, the municipal advisor would be required to amend or supplement the writing(s) and promptly deliver the amended writing(s) or supplement to the client. The same would be true in the case of material conflicts of interest discovered after the relationship documentation was last provided to the client. The amendment and supplementation requirement in proposed section (c) would apply to any material changes and additions that are discovered, or should have been discovered, based on the exercise of reasonable diligence by the municipal advisor. Any amendments or supplementation also would be subject to the requirements of the proposed rule change that would apply as if it were the first relationship documentation provided to the client.

Proposed Rule G–42(c) is modeled in part on Rule G–23, which requires a broker, dealer or municipal securities dealer (''dealer'') that enters into a financial advisory relationship with an issuer to evidence that relationship in writing prior to, upon or promptly after the inception of that relationship. Like Rule G–23, proposed section (c) would not require that the writing(s) evidencing the relationship be a bilateral agreement or contract. For example, if state law provided for the procurement of municipal advisory services in a manner that did not require a writing sufficient to establish a bilateral agreement, a municipal advisor could send its client a writing, such as a letter that references the procurement document and contains the terms and disclosures required by proposed Rule G–42(b) and (c) to evidence its municipal advisory relationship with its municipal entity or obligated person client.

Recommendations and Review of Recommendations of Other Parties

Section (d) of Proposed Rule G–42 would provide that a municipal advisor must not recommend that its client enter into any municipal securities transaction or municipal financial product unless the municipal advisor has determined, based on the information obtained through the reasonable diligence of the municipal advisor, whether the transaction or product is suitable for the client.[17] Proposed section (d) also contemplates that a municipal advisor may be requested by the client to review and determine the suitability of a recommendation made by a third party to the client. If a client were to request this type of review, and such review were within the scope of the engagement, the municipal advisor's determination regarding the suitability of the third-party's recommendation regarding a municipal securities transaction or municipal financial product would be subject to the same reasonable diligence standard—requiring the municipal advisor to obtain relevant information through the exercise of reasonable diligence.

As to both types of review, the municipal advisor would be required under proposed section (d) to inform its municipal entity or obligated person client of 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, or is not, suitable for the client; and 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. The proposed rule does not include requirements regarding how such information must be communicated by the municipal advisor to the client, and a municipal advisor would be permitted to choose the appropriate method by which to communicate the information

[15] While no acknowledgement from the client of its receipt of the documentation would be required, a municipal advisor must, as part of the duty of care it owes its client, reasonably believe that the documentation was received by its client.

[16] Compliance with this requirement could be achieved in the same manner, and (so long as done upon or prior to engaging in municipal advisory activities for the client) concurrently with providing to the client the information required under proposed subsection (b)(ii). However, the description of the events contained in Forms MA or MA–I must be sufficiently specific to allow a municipal entity or obligated person client to understand the nature of any disclosed legal or disciplinary event. In addition, the municipal advisor must provide detailed information specifying where the client could access such forms electronically. *See supra* note 10 and accompanying text.

[17] Some securities market participants are required to make only recommendations that are ''consistent with'' their customer's best interests. (*See* FINRA Notice 12–25, Suitability (May 2012)). As provided in proposed section (a) and paragraph .02 of the Supplementary Material to Proposed Rule G–42, a municipal advisor to a municipal entity client owes the client a fiduciary duty that includes a duty of loyalty in addition to the duty of care, which requires the municipal advisor to deal honestly and with the utmost good faith with the 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's recommendations of municipal securities transactions and municipal financial products to a municipal entity client, as is the case with all municipal advisory activities performed for a municipal entity client, must comport with the municipal advisor's fiduciary duty and particularly its duty of loyalty. The MSRB considers the duty of loyalty described in Proposed Rule G–42 to be even more rigorous than a standard requiring consistency with a client's best interests.

to its client so long as it comports with the duty of care owed.

Section (d), like other provisions of Proposed Rule G–42, would reflect the basic principle that the client controls the scope of the engagement with its municipal advisor (with the agreement of the municipal advisor). For example, a municipal advisor's engagement may be limited in scope because the municipal advisor's client already reached a decision regarding a particular municipal securities transaction or municipal financial product, or engaged another professional to undertake certain duties in connection with a municipal securities transaction or municipal financial product. Paragraph .04 of the Supplementary Material would provide that a municipal advisor and its client could limit the scope of the municipal advisory relationship to certain specified activities or services. A municipal advisor, however, would not be permitted to alter the standards of conduct or duties imposed by the proposed rule with respect to that limited scope.

The proposed rule change would adopt, and apply to municipal advisors, the existing MSRB interpretive guidance regarding the general principles currently applicable to dealers for determining whether a particular communication constitutes a recommendation of a securities transaction.[18] Consistent with the approach in the case of dealers, a municipal advisor's communication to its client that could reasonably be viewed as a ''call to action'' to engage in a municipal securities transaction or enter into a municipal financial product would be considered a recommendation and obligate the municipal advisor to conduct a suitability analysis of its recommendation. Depending on all of the facts and circumstances, communications by a municipal advisor to a client that concern minor or ancillary matters that relate to, but are not recommendations of, a municipal securities transaction or municipal financial product might constitute advice (and therefore trigger many other provisions of the proposed rule) but would not trigger the suitability obligation set forth in proposed section (d).

Paragraph .08 of the Supplementary Material would provide guidance related to a municipal advisor's suitability obligations. Under this provision, a municipal advisor's determination of whether a municipal securities transaction or municipal financial product is suitable for its client must be based on numerous factors, as applicable to the particular type of client, including, but not limited to: 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 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 the municipal advisor has conducted a reasonable inquiry.

In connection with a municipal advisor's obligation to determine the suitability of a municipal securities transaction or a municipal financial product for a client, which should take into account its knowledge of the client, paragraph .09 of the Supplementary Material would require a municipal advisor to know its client. The obligation to know the client would require a municipal advisor to use reasonable diligence to know and retain essential facts concerning the client and the authority of each person acting on behalf of the client, and is similar to requirements in other regulatory regimes.[19] The facts ''essential'' to knowing one's client would 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, rules and regulations.

As a practical matter, it is understood that a client could 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 municipal advisor would not be required to disengage from the municipal advisory relationship on that basis.

Specified Prohibitions

Subsection (e)(i) of Proposed Rule G–42 would prohibit discrete conduct or activities that would conflict, or would be highly likely to conflict, with the core standards of conduct—the duty of loyalty and the duty of care—applicable to municipal advisors under Proposed Rule G–42 and the Exchange Act.

Paragraph (e)(i)(A) would prohibit a municipal advisor from receiving compensation from its client that is excessive in relation to the municipal advisory activities actually performed for the client. Paragraph .10 of the Supplementary Material would provide additional guidance on how compensation would be determined to be excessive. Included in paragraph .10 are several factors that would be considered when evaluating the reasonableness of a municipal advisor's compensation relative to the nature of the municipal advisory activities performed, including, but not limited to: the municipal advisor's expertise, the complexity of the municipal securities transaction or municipal financial product, whether the fee is contingent upon the closing of the municipal securities transaction or municipal financial product, the length of time spent on the engagement and whether the municipal advisor is paying any other relevant costs related to the municipal securities transaction or municipal financial product.

Paragraph (e)(i)(B) would prohibit municipal advisors from delivering an invoice for fees or expenses for municipal advisory activities that does not accurately reflect the activities actually performed or the personnel that actually performed those activities. This provision would not prohibit a municipal advisor from including a discount for the services it actually performed, if accurately disclosed.

Paragraph (e)(i)(C) would prohibit a municipal advisor from making any representation or submitting any information that the municipal advisor knows or should know is either materially false or materially misleading due to the omission of a material fact, about its capacity, resources or knowledge in response to requests for proposals or in oral presentations to a client or prospective client for the purpose of obtaining or retaining an

[18] *See* MSRB Rule G–19. *See also* MSRB Notice 2002–30 (Sept. 25, 2002) Notice Regarding Application of Rule G–19, on Suitability of Recommendations and Transactions, to Online Communications.

[19] Similar requirements apply to brokers and dealers under FINRA Rule 2090 (Know Your Customer) and swap dealers under Commodity Futures Trading Commission (''CFTC'') Rule 402(b) (General Provisions: Know Your Counterparty), 17 CFR 23.402(b), found in CFTC Rules, Ch. I, Pt. 23, Subpt. H (Business Conduct Standards for Swap Dealers and Major Swap Participants Dealing with Counterparties, including Special Entities) (17 CFR 23.400 *et. seq.*). 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* CFTC Rule 401(c) (defining ''special entity'') (17 CFR 23.401(c)).

engagement to perform municipal advisory activities. Note that, additionally, the MSRB's existing fundamental fair practice rule, Rule G–17, precludes municipal advisors, in the conduct of their municipal advisory activities, from engaging in any deceptive, dishonest or unfair practice with any person.

Paragraph (e)(i)(D) would prohibit municipal advisors from making or participating in two types of fee-splitting arrangements: (1) Any fee-splitting arrangement with an underwriter on any municipal securities transaction as to which the municipal advisor has provided or is providing advice; and (2) any *undisclosed* fee-splitting arrangement with providers of investments or services to a municipal entity or obligated person client of the municipal advisor.

Paragraph (e)(i)(E) would, generally, prohibit a municipal advisor from making payments for the purpose of obtaining or retaining an engagement to perform municipal advisory activities. However, the provision contains three exceptions. The prohibition would not apply to: (1) Payments to an affiliate of the municipal advisor for a direct or indirect communication with a municipal entity or obligated person on behalf of the municipal advisor where such communication is made for the purpose of obtaining or retaining an engagement to perform municipal advisory activities; (2) reasonable fees paid to another municipal advisor registered as such with the Commission and MSRB for making such a communication as described in subparagraph (e)(i)(E)(1); and (3) payments that are permissible ''normal business dealings'' as described in MSRB Rule G–20. The proposed rule change, however, would not prescribe parameters that would effectively limit a client's ability to decide the source of funds for the payment of fees for services rendered by the municipal advisor.

Principal Transactions

Subsection (e)(ii) of Proposed Rule G–42 would prohibit a municipal advisor to a municipal entity, and any affiliate of such municipal advisor, from engaging in a principal transaction directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing or has provided advice. The ban on principal transactions would apply only with respect to clients that are municipal entities. The ban would not apply to principal transactions between a municipal advisor (or an affiliate of the municipal advisor) and the municipal advisor's obligated person clients. Although such transactions would not be prohibited, importantly, all municipal advisors, including those engaging in municipal advisory activities for obligated person clients, are currently subject to the MSRB's fundamental fair-practice rule, Rule G–17.

Paragraph .07 of the Supplementary Material would provide an exception to the ban on principal transactions in subsection (e)(ii) in order to avoid a possible conflict with existing MSRB Rule G–23, on activities of financial advisors. Specifically, the ban in subsection (e)(ii) would not apply to an acquisition as principal, either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from an issuer all or any portion of an issuance of municipal securities on the basis that the municipal advisor provided advice as to the issuance, because such a transaction is the type of transaction that is addressed, and, in certain circumstances, prohibited by Rule G–23. The purpose of this provision would be to avoid a potential conflict in MSRB rules and provide, until such time as the MSRB may further review and potentially amend Rule G–23, that the specific prohibition against principal transactions contained in subsection (e)(ii) would not prohibit such underwriting transactions, as they are already addressed and prohibited in certain circumstances by Rule G–23.

For purposes of the prohibition in proposed subsection (e)(ii), subsection (f)(i) would define the term ''engaging in a principal transaction'' to mean ''when acting as a principal for one's own account, selling to or purchasing from the municipal entity client any security or entering into any derivative, guaranteed investment contract, or other similar financial product with the municipal entity client.'' This definition draws on the statutory language regarding principal transactions in the Investment Advisers Act.[20] Among other things, the definition was designed to exclude transactions thought to be potentially covered by some commenters, such as the taking of a cash deposit or the payment by a client solely for professional services. Further, paragraph .11 of the Supplementary Material would clarify that the term ''other similar financial products,'' as used in subsection (f)(i), would include a bank loan but only if it is in an aggregate principal amount of $1,000,000 or more and is economically equivalent to the purchase of one or more municipal securities. Bank loans would be included under the specified circumstances because, as a matter of market practice, they serve as a financing alternative to the issuance of municipal securities and pose a comparable, acute potential for self-dealing and other breaches of the fiduciary duty owed by a municipal advisor to a municipal entity client.

Definitions

Section (f) of Proposed Rule G–42 would provide definitions of the terms ''engaging in a principal transaction,'' ''affiliate of the municipal advisor,'' [21] ''municipal advisory relationship,'' [22] and ''official statement.'' [23] Further, for several terms in Proposed Rule G–42 that have been previously defined by federal statute or SEC rules, proposed section (f) would, for purposes of Proposed Rule G–42, adopt the same meanings. These terms would include ''advice;'' [24] ''municipal advisor;'' [25] ''municipal advisory activities;'' [26]

[20] *See* 15 U.S.C. 80b–6(3).

[21] ''Affiliate of the municipal advisor'' would mean ''any person directly or indirectly controlling, controlled by, or under common control with such municipal advisor.'' *See* Proposed Rule G–42(f)(iii).

[22] Proposed Rule G–42(f)(vi) provides that a ''municipal advisory relationship'' would be deemed to exist when a municipal advisor enters into an agreement to engage in municipal advisory activities for a municipal entity or obligated person. The municipal advisory relationship shall be deemed to have ended on the date which is the earlier of (i) the date on which the municipal advisory relationship has terminated pursuant to the terms of the documentation of the municipal advisory relationship required in section (c) of this rule or (ii) the date on which the municipal advisor withdraws from the municipal advisory relationship.

[23] ''Official statement'' would have the same meaning as in MSRB Rule G–32(d)(vii). *See* Proposed Rule G–42(f)(ix).

[24] ''Advice'' would have the same meaning as in Section 15B(e)(4)(A)(i) of the Exchange Act (15 U.S.C. 78*o*–4(e)(4)(A)(i)); SEC Rule 15Ba1–1(d)(1)(ii) (17 CFR 240.15Ba1–1(d)(1)(ii)); and other rules and regulations thereunder. *See* Proposed Rule G–42(f)(ii).

[25] ''Municipal advisor'' would have the same meaning as in Section 15B(e)(4) of the Act, 17 CFR 240.15Ba1–1(d)(1)–(4) and other rules and regulations thereunder; provided that it shall exclude a person that is otherwise a municipal advisor solely based on activities within the meaning of Section 15B(e)(4)(A)(ii) of the Act and rules and regulations thereunder or any solicitation of a municipal entity or obligated person within the meaning of Section 15B(e)(9) of the Act and rules and regulations thereunder.

See Proposed Rule G–42(f)(iv).

[26] ''Municipal advisory activities'' would mean those activities that would cause a person to be a municipal advisor as defined in subsection (f)(iv) (definition of ''municipal advisor'') of Proposed Rule G–42. *See* Proposed Rule G–42(f)(v).

''municipal entity;'' [27] and ''obligated person.'' [28]

Applicability of Proposed Rule G–42 to 529 College Savings Plans and Other Municipal Fund Securities

The regulation of municipal advisors, as the SEC has recognized,[29] is relevant to municipal fund securities.[30] Paragraph .12 of the Supplementary Material emphasizes the proposed rule's application to municipal advisors whose municipal advisory clients are sponsors or trustees of municipal fund securities.

Proposed Amendments to Rule G–8

The proposed amendments to Rule G–8 would require each municipal advisor to make and keep any document created by the municipal advisor that was material to its review of a recommendation by another party or that memorialize its basis for any conclusions as to suitability.

2. Statutory Basis

Section 15B(b)(2) of the Exchange Act [31] provides that:

The 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.

Section 15B(b)(2)(C) of the Exchange Act [32] provides that the MSRB's rules shall:

be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities and municipal financial products, to remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in general, to protect investors, municipal entities, obligated persons, and the public interest.

Section 15B(b)(2)(L)(i) of the Exchange Act [33] requires, with respect to municipal advisors, the Board to adopt rules to prescribe 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.

The MSRB believes that, the proposed rule change is consistent with Sections 15B(b)(2),[34] 15B(b)(2)(C) [35] and 15B(b)(2)(L)(i) [36] of the Exchange Act because it will enhance the protections afforded to municipal bond issuers and investors by providing guidance to municipal advisors that is designed to promote compliance with the standards of conduct, requirements and intent of the Dodd-Frank Act.

In this regard, 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. Adoption of Proposed Rule G–42 will fulfill the need for regulatory guidance with respect to the standards of conduct and duties of municipal advisors and the prevention of breaches of a municipal advisor's fiduciary duty to its municipal entity clients. Proposed Rule G–42 also will establish standards of conduct and duties for municipal advisors when engaging in municipal advisory activities for obligated persons and provide guidance to these municipal 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, Proposed 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 proposed rule change will 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 municipal 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.

The MSRB believes the proposed rule change will enhance municipal entity and obligated person protections by ensuring that these entities have access to sufficient information to make meaningful choices, based on the merits of the municipal advisor, when considering engaging a municipal advisor by requiring municipal advisors to provide detailed disclosures of material conflicts of interest and certain other information prior to or upon the establishment of the municipal advisory relationship. As a result, municipal advisor clients will be able to evaluate municipal advisors on this objective set of information. These protections will also be enhanced as a result of the proposed rule change's guidance for municipal advisors that could assist advisors in complying with, or help prevent breaches of, their fiduciary duty and duty of care, as well as other applicable obligations such as the duty of fair dealing (which is owed under MSRB Rule G–17 by all municipal advisors to all persons). To the extent that this guidance, provided in the supplementary material in the proposed rule change, would increase the likelihood of compliance by municipal advisors, municipal entities and obligated persons will benefit. Investors in municipal bond offerings will also benefit from the proposed rule change to the extent that a municipal entity or obligated person 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.

The proposed rule change would also, to some extent, prescribe means for municipal advisors to help prevent breaches of these duties, which would include, among others: Requirements for the information that must be included in the documentation of the municipal advisory relationship; specified activities (such as certain principal transactions) that would be explicitly prohibited; and disclosure requirements that must accompany a municipal advisor's recommendation regarding a municipal security or a municipal financial product.

Section 15B(b)(2)(L)(iv) of the Exchange Act [37] requires that rules adopted by the Board:

[27] ''Municipal entity'' would ''have the same meaning as in Section 15B(e)(8) of the Act, 17 CFR 240.15Ba1–1(g) and other rules and regulations thereunder.'' *See* Proposed Rule G–42(f)(vii).

[28] ''Obligated person'' would ''have the same meaning as in Section 15B(e)(10) of the Act, 17 CFR 240.15Ba1–1(k) and other rules and regulations thereunder.'' *See* Proposed Rule G–42(f)(viii).

[29] *See* SEC Final Rule, 78 FR at 67472–3.

[30] ''Municipal fund security'' 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.'' The term refers to, among other things, interests in governmentally sponsored 529 college savings plans and local government investment pools.

[31] 15 U.S.C. 78*o*–4(b)(2).

[32] 15 U.S.C. 78*o*–4(b)(2)(C).

[33] 15 U.S.C. 78*o*–4(b)(2)(L)(i).

[34] 15 U.S.C. 78*o*–4(b)(2).

[35] 15 U.S.C. 78*o*–4(b)(2)(C).

[36] 15 U.S.C. 78*o*–4(b)(2)(L)(i).

[37] 15 U.S.C. 78*o*–4(b)(2)(L)(iv).

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 believes that the proposed rule change is consistent with Section 15B(b)(2)(L)(iv) of the Exchange Act [38] because the proposed rule change would impose on all municipal advisors, including small municipal advisors, only the necessary and appropriate regulatory burdens needed to promote compliance with the proposed rule change. To accomplish this, Proposed Rule G–42 would use both a principles and prescriptive-based approach to establish the core standards of conduct in order to, among other things, accommodate the diversity of the municipal advisor population, including small municipal advisors and sole proprietorships, and to provide uniform protections to its clients, investors and the public.

The MSRB recognizes that municipal advisors would incur costs to meet the standards of conduct and duties contained in the proposed rule changes. These costs also could include additional compliance and recordkeeping costs. To ensure compliance with the disclosure obligations of the proposed rule change, municipal advisors could 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 SEC Final Rule which requires disclosure of at least some similar information, such as the disclosure of disciplinary events. Proposed Rule G–42 could also impose additional costs on municipal advisors by requiring the disclosure of additional information directly to clients, some of which must already be submitted to the SEC on SEC Forms MA [39] and MA–I.[40] The MSRB has considered these costs and that there could be some instances of duplicative disclosure, but believes that the overlap in disclosure requirements between the SEC and MSRB will be minimal and that the disclosure requirements of the proposed rule are important elements of Proposed Rule G–42 that protect municipal advisor clients and foster transparency in the municipal advisory marketplace.

As to the potential costs associated with additional recordkeeping requirements, the SEC recognized in its economic analysis [41] of its recordkeeping requirements that 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 advisers are currently subject to the recordkeeping requirements of those regulatory frameworks. Against this back-drop, the MSRB believes that the costs associated with the few additional recordkeeping requirements associated with Proposed Rule G–42 will not be significant.

The MSRB believes that any increase in municipal advisory fees attributable to the additional costs of the proposed rule change will be minimal and that at least the element of fixed costs 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 proposed rule change's standards of conduct and duties could represent a greater percentage of annual revenues, and, thus, such advisors could be more likely to pass those costs along to their advisory clients.

The MSRB also recognizes that, as a result of these costs, some municipal advisors could 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 by articulating the core standard of conduct and duties and obligations of municipal advisors and by prescribing means that would prevent breaches of these duties, the proposed rule change will reduce possible confusion and uncertainty about what is required in order to comply with relevant provisions of the Dodd-Frank Act. Therefore, the proposed rule change likely will reduce certain costs of compliance that might have otherwise been incurred by allowing municipal advisors to more quickly and accurately determine compliance requirements.

The MSRB also believes that the proposed rule change is consistent with Section 15B(b)(2)(G) of the Exchange Act,[42] which provides that the MSRB's rules shall:

> prescribe records to be made and kept by municipal securities brokers, municipal securities dealers, and municipal advisors and the periods for which such records shall be preserved.

The proposed rule change would require, under the proposed amendments to Rule G–8, that a municipal advisor make and keep records of any document created by the 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. The MSRB believes that the proposed amendments to Rule G–8 related to recordkeeping (with the ensuing application of existing Rule G–9 on records preservation) would promote compliance and facilitate enforcement of Proposed Rule G–42, other MSRB rules, and other applicable securities laws and regulations.

B. Self-Regulatory Organization's Statement on Burden on Competition

Section 15B(b)(2)(C) [43] of the Exchange Act requires that MSRB rules not be designed to impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. In addition, Section 15B(b)(2)(L)(iv) [44] of the Exchange 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.

In determining whether these standards have been met, the MSRB was guided by the Board's Policy on the Use of Economic Analysis in MSRB Rulemaking.[45] In accordance with this policy, the Board evaluated the potential impacts of the proposed rule, including in comparison to reasonable alternative regulatory approaches, relative to the baseline that, *inter alia,* deemed municipal advisors to owe a fiduciary duty to their municipal entity clients and established a registration requirement. Based on this evaluation, the MSRB does not believe that the proposed rule change would impose any additional burdens on competition that are not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposed rule may also provide a range of benefits to municipal entities, investors and municipal advisors. Municipal entities and obligated persons will have access to more information about municipal advisors

[38] 15 U.S.C. 78*o*–4(b)(2)(L)(iv).

[39] 17 CFR 249.1300.

[40] 17 CFR 249.1310.

[41] *See* SEC Final Rule, 78 FR at 67619.

[42] 15 U.S.C. 78*o*–4(b)(2)(G).

[43] 15 U.S.C. 78*o*–4(b)(2)(C).

[44] 15 U.S.C. 78*o*–4(b)(2)(L)(iv).

[45] Policy on the Use of Economic Analysis in MSRB Rulemaking, available at *http://www.msrb.org/About-MSRB/Financial-and-Other-Information/Financial-Policies/Economic-Analysis-Policy.aspx*.

and can make better, more informed choices with lower search costs. The availability of additional, objective information and the fostering of merit-based competition among municipal advisors should lead to enhanced issuer protections and improved outcomes. These improvements likely would enhance investor confidence in the integrity of the market. Moreover, the MSRB believes that the proposed rule change will provide 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.

The MSRB considered whether costs associated with the proposed rule change, relative to the baseline, could affect the competitive landscape by leading some municipal advisors to exit the market, curtail their activities, consolidate with other firms, or pass costs on to municipal entity and obligated person clients in the form of higher fees. In addition, the MSRB considered whether the costs associated with the proposed rule, relative to the baseline, could create barriers to entry for firms wishing to offer to engage in municipal advisory activities.

The MSRB recognizes that some municipal advisors may exit the market as a result of the costs associated with the proposed rule relative to the baseline. However, the MSRB believes municipal advisors may exit the market for a number of reasons other than costs associated with the proposed rule. The MSRB also recognizes that some municipal advisors may 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 proposed rule. Finally, the MSRB acknowledges that some potential market entrants may be discouraged from entering the market because of costs or because the requirement to disclose information such as disciplinary events might make attracting business more difficult.

It is also possible that competition for municipal advisory activities may be affected by whether incremental costs associated with requirements of the proposed rule are passed on to advisory clients. The amount of costs passed on may be influenced by the size of the municipal advisory firm. For smaller municipal advisors with fewer clients, the incremental costs associated with the requirements of the proposed rule 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. As a result, the competitive landscape may be altered by the potentially impaired ability of smaller firms to compete for advisory clients.

In addition to the factors noted above that may affect smaller advisory firms, the MSRB understands that some small municipal advisors and sole proprietors may not employ full-time compliance staff and that the cost of ensuring compliance with the requirements of the proposed rule may be proportionally higher for these smaller firms.

The MSRB believes these costs represent only those necessary to achieve the purposes of the Exchange Act. Relative to draft Rule G–42 as initially published for comment,[46] the MSRB has made efforts to minimize costs that could affect the competitive landscape including, narrowing the scope of the conflicts that must be disclosed, specifying a less burdensome method for disclosing conflicts and disciplinary actions and documenting the municipal advisory relationship, clarifying the obligations owed by municipal advisors to obligated persons, and removing a number of other previously considered requirements.

Further, while exit, consolidation, or a reduced number of new market entrants may lead to a reduced pool of municipal advisors, the SEC concluded in the SEC Final Rule (on the permanent registration of municipal advisors) that the market would be likely to remain competitive despite the potential exit of some municipal advisors (including small entity municipal advisors), consolidation of municipal advisors, or lack of new entrants into the market.[47]

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

The MSRB solicited comment on the proposed rule change in the First Request for Comment, requesting comment on a draft of Rule G–42 and draft amendments to Rules G–8 and G–9, and a second notice requesting comment on a revised draft of Rule G–42 and draft amendments to Rules G–8 and G–9.[48]

The MSRB received forty-six comment letters in response to the First Request for Comment,[49] and nineteen

[46] The MSRB sought comment on the initial draft Rule G–42 (''Initial Draft Rule'') and draft amendments to Rules G–8 and G–9 in MSRB Notice 2014–01 (Jan. 9, 2014) (''First Request for Comment'').

[47] *See* SEC Final Rule, 78 FR at 67608.

[48] *See* MSRB Notice 2014–12 (Jul. 23, 2014) (''Second Request for Comment''). The draft rule text published in the Second Request for Comment is hereinafter the ''Revised Draft Rule.''

[49] Comments were received in response to the First Request for Comment from: Acacia Financial Group, Inc.: Letter from Kim M. Whelan, Co-President, dated March 10, 2014 (''Acacia''); American Bankers Association: Letter from Cristeena G. Naser, Vice President and Senior Counsel, dated March 4, 2014 (''ABA''); American Council of Engineering Companies: Letter from David A. Raymond, President and CEO, dated March 7, 2014 (''ACEC''); American Public Transportation Association: Letter from Michael P. Melaniphy, President and CEO, dated March 10, 2014 (''APTA''); Bond Dealers of America: Letter from Michael Nicholas, Chief Executive Officer, dated March 10, 2014 (''BDA''); Cape Cod Five Cents Savings Bank: Letter from Dorothy A. Savarese, President and Chief Executive Officer, dated March 10, 2014 (''Cape Cod Savings''); Chancellor Financial Associates: Email from William J. Caraway, President, dated January 14, 2014 (''Chancellor Financial''); Coastal Securities: Letter from Chris Melton, Executive Vice President, dated March 10, 2014 (''Coastal''); College Savings Foundation: Letter from Mary G. Morris, Chair, dated March 10, 2014 (''CSF''); College Savings Plans Network: Letter from Betty Everitt Lochner, Director, Guaranteed Education Tuition Program, dated March 10, 2014 (''CSPN''); Cooperman Associates: Letter from Joshua G. Cooperman dated March 10, 2014 (''Cooperman''); Erika Miller: Email dated February 4, 2015; FCS Group: Letter from Taree Bollinger, Vice President, dated March 17, 2014 (''FCS''); First River Advisory L.L.C.: Letter from Shelley J. Aronson, President, dated January 16, 2014 (''First River Advisory''); First Southwest Company: Letter from Hill A. Feinberg, Chairman and Chief Executive Officer, and Michael G. Bartolotta, Vice Chairman, dated March 7, 2014 (''First Southwest''); Frost Bank: Letter from William H. Sirakos, Senior Executive Vice President, dated March 10, 2014 (''Frost''); George K. Baum & Company: Letter from Guy E. Yandel, EVP and Head of Public Finance, Dana L. Bjornson, EVP, CFO and Chief Compliance Officer, and Andrew F. Sears, SVP and General Counsel, dated March 10, 2014 (''GKB''); Government Finance Officers Association: Letter from Dustin McDonald, Director, Federal Liaison Center, dated March 13, 2014 (''GFOA''); Government Investment Officers Association: Letter from Laura Glenn, President, *et al.,* dated March 7, 2014 (''GIOA''); Investment Company Institute: Letter from Tamara K. Salmon, Senior Associate Counsel, dated March 4, 2014 (''ICI''); J.P. Morgan: Letter from Paul N. Palmeri, Managing Director, dated March 10, 2014 (''JP Morgan''); Kutak Rock LLP: Letter from John J. Wagner dated March 10, 2014 (''Kutak''); Lamont Financial Services Corporation: Letter from Robert A. Lamb, President, dated March 10, 2014 (''Lamont''); Lewis Young Robertson & Burningham, Inc.: Letter from Laura D. Lewis, Principal, dated March 3, 2014 (''Lewis Young''); MSA Professional Services, Inc.: Letter from Gilbert A. Hantzsch, CEO, dated March 10, 2014 (''MSA''); National Association of Bond Lawyers: Letter from Allen K. Robertson, President, dated March 18, 2014 (''NABL''); National Association of Health and Educational Facilities Finance Authorities: Letter from Pamela Lenane, President, David J. Kates, Chapman and Cutler LLP, and Charles A. Samuels, Mintz Levin, dated March 10, 2014 (''NAHEFFA''); National Association of Independent Public Finance Advisors: Letter from Jeanine Rodgers Caruso, President, dated March 10, 2014 (''NAIPFA''); National Healthcare Capital LLC: Letter from Richard Plumstead, dated March 10, 2014; New York State Bar Association: Letter from Peter W. LaVigne, Chair of the Committee, dated March 12, 2014 (''NY State Bar''); Northland Securities, Inc.: Letter from John R. Fifield, Jr., Director of Public Finance/Senior Vice President, dated March 7, 2014 (''Northland''); Oppenheimer & Co. Inc.: Email from John Rodstrom dated March

comment letters in response to the Second Request for Comment.[50] The comments are summarized below by topic and MSRB responses are provided.[51]

10, 2014 (''Oppenheimer''); Parsons Brinckerhoff Advisory Services, Inc.: Letter from Mark E. Briggs, President, dated March 10, 2014 (''Parsons''); Piper Jaffray: Letter from Frank Fairman, Managing Director, Head of Public Finance Services, dated March 10, 2014 (''Piper Jaffray''); Public Financial Management, Inc.: Letter from John H. Bonow, Chief Executive Officer, dated March 10, 2014 (''PFM''); Public Resources Advisory Group: Letter from Thomas Huestis dated March 10, 2014 (''PRAG''); Raftelis Financial Consultants, Inc.: Letter from Lex Warmath dated March 10, 2014 (''Raftelis Financial''); Securities Industry and Financial Markets Association: Letter from Leslie M. Norwood, Managing Director and Associate General Counsel, dated March 10, 2014 (''SIFMA''); Sutherland Asbill & Brennan LLP: Letter from Michael B. Koffler dated March 10, 2014 (''Sutherland''); Wells Fargo Advisors, LLC: Letter from Robert J. McCarthy, Director of Regulatory Policy, dated March 10, 2014 (''Wells Fargo''); Winters & Co. Advisors, LLC: Letter from Christopher J. Winters dated March 10, 2014 (''Winters LLC''); WM Financial Strategies: Letter from Joy A. Howard, Principal, dated March 10, 2014 (''WM Financial''); Woodcock & Associates, Inc.: Email from Christopher Woodcock dated January 14, 2014 (''Woodcock''); Wulff, Hansen & Co.: Letter from Chris Charles, President, dated March 17, 2014 (''Wulff Hansen''); Yuba Group: Letter from Linda Fan, Managing Partner, dated March 7, 2014 (''Yuba''); Zion's First National Bank: Letter from W. David Hemingway, Executive Vice President, dated March 10, 2014 (''Zion'').

[50] Comments were received in response to the Second Request for Comment from: ABA: Letter from Cristeena Naser, Vice President, Center for Securities, Trust & Investments, dated August 25, 2014; ACEC: Letter from David A. Raymond, President and CEO, dated August 25, 2014; BDA: Letter from Michael Nicholas, Chief Executive Officer, dated August 25, 2014; Columbia Capital Management, LLC: Letter from Jeff White, Principal, dated August 25, 2014 (''Columbia Capital''); Dave A. Sanchez: Letter dated August 25, 2014 (''Sanchez''); Financial Services Roundtable: Letter from Richard Foster, Vice President and Senior Counsel for Regulatory and Legal Affairs, dated August 25, 2014 (''FSR''); Florida Division of Bond Finance: Letter from J. Ben Watkins III, Director, dated August 22, 2014 (''FLA DBF''); GFOA: Letter from Dustin McDonald, Director, Federal Liaison Center, dated September 2, 2014; ICI: Letter from Tamara K. Salmon, Senior Associate Counsel, dated August 19, 2014; Mr. Bart Leary: Email dated July 23, 2014 (''Leary''); Lewis Young: Letter from Laura D. Lewis, Principal, dated August 25, 2014; NAIPFA: Letter from Jeanine Rodgers Caruso, President, dated August 25, 2014; New York State Bar: Letter from Peter W. LaVigne, Chair of the Committee, dated August 27, 2014; Piper Jaffray: Letter from Frank Fairman, Managing Director, Head of Public Finance Services, dated August 25, 2014; SIFMA: Letter from Leslie M. Norwood, Managing Director and Associate General Counsel, dated August 25, 2014; Southern Municipal Advisors, Inc.: Letter from Michael C. Cawley, Senior Consultant, dated August 25, 2014 (''SMA''); Wells Fargo: Letter from Robert J. McCarthy, Director of Regulatory Policy, dated August 25, 2014; WM Financial: Letter from Joy A. Howard, Principal, dated August 25, 2014; and Zion: Letter from W. David Hemingway, Executive Vice President, dated August 25, 2014.

[51] The draft rule text included in the First Request for Comment is referred to herein as the ''Initial Draft Rule;'' the draft rule text included in the Second Request for Comment is referred to herein as the ''Revised Draft Rule.''

Standards of Conduct

Under Proposed Rule G–42(a), a municipal advisor would be subject to a duty of care as to its obligated person clients under subsection (a)(i) and a fiduciary duty as to its municipal entity clients under subsection (a)(ii) when engaging in municipal advisory activities for such clients. Several commenters raised concerns relating to the proposed standards of conduct that would apply to municipal advisors.

Scope of the Fiduciary Relationship

In the First Request for Comment, the MSRB proposed that a municipal advisor be subject to a fiduciary duty when engaging in municipal advisory activities for municipal entity clients. Subsequently, in the Second Request for Comment, the MSRB asked whether the Revised Draft Rule should uniformly apply the proposed fiduciary standard to a municipal advisor in its relationships with all of its clients, including obligated persons. A number of commenters opposed extending the application of the fiduciary standard to municipal advisors in connection with their obligated person clients.[52]

The MSRB believes that the application of the fiduciary standard is appropriately limited to municipal advisors when engaging in municipal advisory activities for or on behalf of municipal entity clients and strikes the appropriate balance. Proposed Rule G–42 establishes a minimum standard, which, as noted by NABL, does not limit an obligated person client and its municipal advisor from agreeing to a higher standard of conduct, or incorporating other requirements or protections in the municipal advisory relationship.

Scope of the Duty/529 Plans

Proposed paragraph .01 of the Supplementary Material provides that a municipal advisor acting in accordance with the duty of care must undertake reasonable investigation to determine that it is not basing any recommendation made to a client on materially inaccurate or incomplete information. In response to the First and Second Request for Comment, ICI stated that municipal advisors to 529 college savings plans (''529 plans'') should not be required to verify the veracity or completeness of the information provided to the municipal advisor by authorized state employees or officials who are authorized to act on behalf of the 529 plan. ICI requested that paragraph .01 of the Supplementary Material be revised not to require municipal advisors to investigate whether information is materially inaccurate or incomplete when it is provided to the municipal advisor by persons who are authorized by the client to act on behalf of a state's 529 plan.

Neither the First Request for Comment nor the Second Request for Comment contemplated that municipal advisors in municipal advisory relationships with 529 plans would be exempted or excluded, in whole or in part, from the proposed core standards of conduct, including aspects of the duty of care that a municipal advisor owes to a client. The MSRB believes that exempting municipal advisors from the proposed core standards of conduct would reduce the protections that Congress through the Dodd-Frank Act intended to provide to municipal entity clients and investors in 529 plan securities.

Fiduciary Duty—Authority

In response to the Second Request for Comment, Sanchez commented that the MSRB lacks the statutory authority to define ''fiduciary duty'' or to prescribe means designed to effectuate the performance of that duty.

As discussed above, the Exchange Act grants the MSRB statutory authority to adopt rules with respect to municipal advisors engaging in municipal advisory activities that are designed to, among other things, prevent fraudulent and manipulative acts and practices, and acts, practices or courses of business that are not consistent with a municipal advisor's fiduciary duty to its clients.[53] Accordingly, the MSRB has concluded that it is properly exercising the authority granted to it by statute.

Fiduciary Duty—Standards

In response to the First Request for Comment, NABL stated that the Initial Draft Rule should draw on established common law and similar standards that NABL believes are intended to provide substantive guidance regarding fiduciary duties (*e.g.,* the standards applicable to attorneys), rather than the standards applicable to broker-dealers or registered investment advisers. NABL argued that the attorney-client relationship is more comparable to the municipal advisor-client relationship

[52] *See, e.g.,* comment letters from: ABA, BDA, Cape Cod Savings, Cooperman, GKB, Kutak, Lewis Young, NABL, NAHEFFA, Parsons, Piper Jaffray and SIFMA. A few commenters, including First River Advisory, NAIPFA and Yuba, supported the application of a fiduciary duty to a municipal advisor when engaging in municipal advisory activities on behalf of an obligated person client.

[53] *See, e.g.,* 15 U.S.C. 78*o*–4(b)(2)(C); and 15 U.S.C. 78*o*–4(b)(2)(L)(i).

because both can have a wide spectrum of scopes of responsibilities, similar contexts in which there are interactions with the client, and a longer duration over which the representation occurs. BDA similarly believed that the fiduciary standards set forth in the Initial Draft Rule would not operate like other well-established standards, such as those for attorneys, and that the MSRB did not justify why the standards for municipal advisors would deviate from those standards as outlined in the Model Rules of Professional Conduct for attorneys (''Model Rules''). Accordingly, BDA suggested that Proposed Rule G–42 should adopt or parallel the same fiduciary duty standards used by other similarly situated professionals.

In developing Proposed Rule G–42, the MSRB consulted various codes of conduct and sources of federal and state law regarding the duties and obligations of a fiduciary that apply to professionals who are, or, in certain relationships, may be, fiduciaries. Some provisions of the proposed rule reflect principles incorporated from MSRB Rule G–17, including the duties of dealers to issuers, while other provisions were based on principles and requirements in the Investment Advisers Act. The MSRB believes the Investment Advisers Act is particularly relevant in developing a rule regarding fiduciary duties and obligations, and notes that the SEC also considered the Investment Advisers Act informative as it developed the SEC Final Rule.[54] Moreover, the MSRB believes it is important to establish rules and standards that address the practices of various types of municipal advisors and their clients, and that the provisions addressing the duties and obligations of a fiduciary are tailored to address the unique characteristics of the municipal securities market and the variety of responsibilities undertaken by municipal advisors in their relationships with municipal entity and obligated person clients. The MSRB notes that, to the extent that Proposed Rule G–42 does not specifically prescribe or prohibit certain conduct, or address certain activity, common law regarding fiduciary obligations and duties may be referenced by a judicial or adjudicatory decision-maker.

Fiduciary Duty—Obligated Persons

A number of commenters raised concerns that Proposed Rule G–42 implicitly and inappropriately imposes fiduciary duty obligations on municipal advisors whose clients are obligated persons without a demonstrated need for a more robust regulatory framework than that adopted by Congress or the SEC.[55] Those commenters believed that the treatment accorded to obligated persons should be distinguished from that accorded to municipal entities because, as they stated, obligated person clients do not handle public funds, are private, domestic and international for-profit companies or not-for-profit businesses, and, therefore, operate with a different level of public accountability. Overall, these commenters believed that fiduciary duties should not be mandatorily extended to benefit obligated persons.

NAHEFFA suggested that the duty of care and the requirements of the Initial Draft Rule G–42(b)–(f) be revised to state that municipal advisors owe a fiduciary duty only to their municipal entity clients. In the alternative, NAHEFFA requested that the MSRB provide clarification on the legal and practical distinctions among the standards and duties and obligations of municipal advisors vis-à-vis both types of clients, including a clarification that an alleged violation of the duty of care would be subject to review under a negligence standard and an alleged violation of the duty of loyalty would require evidence of intent. Generally, NAHEFFA supported either a revised Rule G–42, or a separate rule that would simplify and reflect the duties and obligations of a municipal advisor with respect to its obligated person clients. NAHEFFA suggested that, as to obligated person clients, the duty should be to exercise professional judgment and expertise in providing services and to deal fairly with its clients. Similarly to NAHEFFA, BDA requested that the MSRB revise Proposed Rule G–42 to more clearly state and distinguish between the duties and obligations that municipal advisors would owe to each of the two types of clients.

ABA commented that the MSRB lacked the requisite authority to impose a fiduciary duty on municipal advisors with respect to their obligated person clients, and that even if it had the authority, such a standard would be unworkable since banks would have difficulty identifying which of their many customers were obligated persons. ABA stated that the extension of a fiduciary duty to municipal advisors in their relationship with their obligated person clients would result in a significant risk that banks would inadvertently violate regulatory requirements by becoming an unwitting municipal advisor with respect to a client they did not know was an obligated person. Moreover, the banks would run the corresponding risk of violating the attendant fiduciary duty applicable to such municipal advisor.

More specifically, Sanchez commented that the language in Revised Draft Rule G–42(b)(i)(A) and (b)(i)(G) appeared to import the duty of loyalty and duty of care into representations of obligated persons by using the phrase ''unbiased and competent advice'' with respect to advice provided to or on behalf of obligated persons. He suggested that these provisions be revised to say ''impair its ability to render advice to or on behalf of the obligated person in accordance with the standards of conduct required in clause (a)'' in lieu of the phrase referencing ''unbiased and competent advice.''

Neither the Initial Draft Rule nor the Revised Draft Rule would deem municipal advisors to owe a fiduciary duty to obligated person clients, and the MSRB disagrees with the view that either the Initial or Revised Draft Rule implicitly and inappropriately imposed fiduciary duty obligations to such clients. After carefully considering the comments, the MSRB has not modified Proposed Rule G–42(a), on standards of conduct. Further, Proposed Rule G–42 follows the approach taken in the Dodd-Frank Act, deeming a municipal advisor to owe a fiduciary duty only to its municipal entity clients. However, although the Exchange Act fiduciary duty standard would not apply to a municipal advisor advising an obligated person client, all municipal advisors are subject to fair-dealing obligations under MSRB Rule G–17, which already requires a municipal advisor to deal fairly with *all* persons and prohibits engaging in any deceptive, dishonest or unfair practice. Moreover, the provisions in Proposed Rule G–42(b)–(f) appropriately establish the duties and obligations of municipal advisors. The MSRB notes that these duties are, in part, based on similar existing duties for other regulated entities (*e.g.,* underwriters' duties to issuers), which are separate and apart from a fiduciary duty. Therefore, the MSRB does not believe Proposed Rule G–42 creates an implicit fiduciary duty for municipal advisors with respect to the advice they provide to obligated person clients.

The MSRB agrees with Sanchez's specific comments regarding paragraphs (b)(i)(A) and (b)(i)(G) of the Revised Draft Rule and has revised the proposed rule change to clearly differentiate between the handling of conflicts of

[54] *See generally,* SEC Final Rule, 78 FR 67467.

[55] *See* letters from: ABA, BDA, Cape Cod Savings, GKB, Kutak, Lewis Young, NABL, NAHEFFA, Parsons, Piper Jaffray, Sanchez and SIFMA. On the other hand, NAIPFA, First River Advisory and Yuba supported imposing fiduciary duties upon municipal advisors with respect to the advice they provide to obligated persons.

interest under the duty of loyalty, as discussed in paragraph .02 of the Supplementary Material, and conflicts under the disclosure requirements that are applicable to all municipal advisory clients as part of a municipal advisor's duty of care, as discussed in paragraph .01 of the Supplementary Material. Specifically, under proposed subsection (a)(ii), the duty of loyalty in the proposed rule change, a municipal advisor must not engage in municipal advisory activities with a municipal entity client if it cannot manage or mitigate its conflicts of interest in a manner that will permit it to act in the municipal entity's best interests. Conversely, under proposed section (c) of Proposed Rule G–42 and as discussed further with respect to proposed paragraph .05 of the Supplementary Material, a municipal advisor can continue to serve as a municipal advisor to its municipal entity or obligated person client when an actual or potential conflict of interest that could be reasonably anticipated to impair its ability to provide that advice exists, so long as such conflict of interest is disclosed and addressed in accordance with the relevant provisions of Proposed Rule G–42 [56] and the municipal advisor can satisfy the applicable standards of conduct described in section (a).

NAHEFFA requested that the MSRB clarify the legal distinctions between the duty of care and duty of loyalty, and suggested that the state of mind standard to determine a violation of the duty of care should be negligence, and the state of mind standard regarding a violation of the duty of loyalty should be intent. In response to NAHEFFA's request for clarification regarding such standards, the MSRB believes it would be appropriate for the courts and other adjudicatory authorities to determine the ''state-of-mind'' elements when applying the standards of conduct of Proposed Rule G–42 to specific sets of facts and circumstances presented, drawing on existing jurisprudence regarding analogous duties of care and fiduciary obligations.

In response to ABA's comment, the MSRB again notes that determining which activities constitute municipal advisory activities requires a legal interpretation of the SEC Final Rule. Such authority is vested with the SEC rather than the MSRB.

Finally, the MSRB notes again that the standards of conduct in Proposed Rule G–42 would be minimum requirements, which the MSRB has developed to empower the client to a large extent to determine the scope of services and control the engagement with the municipal advisor, and as suggested by NABL, any municipal advisor and its client may agree to more stringent standards of conduct for their specific engagement.

Duty of Care—Supplementary Material .01

In response to the Second Request for Comment, WM Financial challenged the requirement that a municipal advisor ''undertake a reasonable investigation to determine that it is not basing any recommendation on materially inaccurate or incomplete information.'' While WM Financial agreed that a municipal advisor should make a reasonable investigation in order to determine whether a recommendation is in a client's best interest, WM Financial believed that a municipal advisor should be able to rely on publicly-available documents as being true and accurate, and should be able to assume that any additional information provided to it by the municipal entity is also true and accurate. WM Financial believed that requiring the municipal advisor to verify the accuracy of the information it receives from a client imposes an inappropriate burden. As noted above, ICI similarly opposed the requirement in the context of 529 plans, for which the municipal advisor that is also acting as a plan sponsor would typically work with and rely upon state employees who are authorized to represent a state's plan and requested revisions to paragraph .01 of the Supplementary Material.

Proposed paragraph .01 of the Supplementary Material would provide, as a core general standard, that a municipal advisor must undertake a reasonable investigation to determine that it is not basing any recommendation on materially inaccurate or incomplete information. There is no exception for information that is provided to the advisor by the client. The MSRB believes that the provisions of proposed paragraph .01 of the Supplementary Material remain appropriate and, as discussed above, does not believe that advisors to 529 plans should be relieved from an obligation to inquire as to the accuracy of material that is relevant to a municipal advisor's recommendation provided by its client or other parties. The MSRB further believes this provision of proposed paragraph .01 of the Supplementary Material would provide an objective standard for when it is appropriate for a municipal advisor to rely on information provided by a client when making a recommendation to such client, including representatives of a 529 plan authorized to act on behalf of the plan. Finally, because proposed paragraph .01 would require municipal advisors to undertake only a ''reasonable investigation'' of the veracity of the information on which it is basing a recommendation, municipal advisors would not be required to go to the impractical lengths suggested by commenters. The MSRB believes this standard would be sufficient to allow municipal advisors to assess their risk exposure to any reliance on that information and determine what potential mitigating actions need to be taken.

Sanchez also commented that the MSRB should ''consider whether the information for which 'a municipal advisor must have a reasonable basis for' incorporated in [subparagraphs] (a) through (c) [of paragraph .01 of the Supplementary Material] is not already addressed in the standards of conduct required of municipal advisors by MSRB Rule G–17 and general antifraud rules related to municipal securities disclosure.'' As such, he suggested deleting those provisions of paragraph .01 of the Supplementary Material to avoid unnecessarily duplicative regulatory requirements. The MSRB has decided to retain those provisions because it believes they would provide additional guidance regarding the proposed duty of care and would assist municipal advisors in satisfying that duty without unnecessarily duplicating the principles of MSRB Rule G–17 or other federal securities anti-fraud statutes.

Finally, SIFMA noted that, while the requirement for a municipal advisor to make a reasonable inquiry—regarding the facts that are relevant to a client's determination to pursue a particular course of action or that form the basis of any advice to the client—could be appropriate in the context of arranging a municipal securities issuance, it could be cost prohibitive in the case of ordinary brokerage and related advice, given the number of trades potentially involved, timing considerations and the general context of broker-related advice. Therefore, SIFMA did not believe that such a standard should be applied in addition to otherwise applicable suitability requirements that would attach to recommendations made in the context of brokerage/securities

[56] Municipal advisors would be required to disclose and document such a material conflict of interest under Proposed Rule G–42(b) and (c) and paragraph .05 of the Supplementary Material. With respect to municipal entity clients, municipal advisors also would need to provide an explanation to the client of how the municipal advisor intends to manage or mitigate its conflict in a manner that will permit it to act in the municipal entity's best interests.

execution services. The MSRB believes that the duties and standards in the proposed rule are appropriately applied to municipal advisory activities (other than the undertaking of a solicitation), and notes that a municipal advisor to a municipal entity client will owe a statutory fiduciary duty to the client. If the conduct SIFMA describes constitutes the giving of advice under the SEC rules providing for the registration of municipal advisors as discussed in the SEC Final Rule,[57] then Proposed Rule G–42 would apply in its entirety. Likewise, if such conduct did not constitute the giving of advice under those rules, then Proposed Rule G–42 would not apply.

Duty of Loyalty—Supplementary Material .02

In response to the First Request for Comment, ACEC and APTA indicated that they believed there are circumstances when the duty of loyalty could directly conflict with an engineer's professional and ethical responsibilities, and expressed concerns as to how such conflicts could affect engineering firms' business. Both ACEC and APTA specifically stated that, in the course of providing professional engineering services to a client, circumstances could arise in which the engineer would find himself or herself facing a conflict between breaching its fiduciary duty in its role as municipal advisor and violating the ethical obligations to which the engineer is subject under applicable state law and regulation, or one or more professional associations. According to ACEC, in such circumstances, it would be detrimental to the health, safety and welfare of the public to prioritize the fiduciary duty the engineer municipal advisor owed to its client. ACEC argued that paragraph .02 of the Supplementary Material, therefore, would not serve the public interest and requested that the MSRB address how this type of conflict could be managed.

The MSRB notes that SEC Rule 15Ba1–1(d)(2)(v) excludes engineers providing engineering advice from the definition of municipal advisor.[58] The MSRB further notes that the same and similar issues raised by the commenters in response to the First Request for comment also were raised with the SEC during its rulemaking to establish the registration regime for municipal advisors. In the SEC Final Rule, the SEC provided greater clarity to engineers concerning the definition of ''municipal advisor'' and the scope of the exclusion for engineers.[59] If, given that guidance, an engineer were in fact to engage in municipal advisory activities, it would be subject to the statutory fiduciary duty to a municipal entity client, and, in the MSRB's view, appropriately subject to the duty of loyalty provisions in Proposed Rule G–42. Under certain circumstances, if a material conflict of interest would prevent the municipal advisor from being able to act in accordance with the standards of conduct of section (a) of Proposed Rule G–42, which the MSRB believes would be rare, the firm might need to determine not to provide municipal advice if it preferred to provide engineering services.

Disclosure of Conflicts of Interest

The MSRB received a number of comments regarding section (b) of Proposed Rule G–42 on required disclosures of material conflicts of interest by municipal advisors to their clients. Generally, commenters were supportive of, or did not express an objection to, requiring municipal advisors to provide written disclosure of material conflicts of interest. However, some commenters did express concerns about some of the facets of the disclosure requirements; those concerns are described below and followed by the MSRB's response.

Compensation Arrangements

Several commenters expressed concern regarding paragraph (b)(i)(F) of Proposed Rule G–42, which requires municipal advisors to disclose conflicts of interest arising from compensation arrangements that are contingent on the size or closing of any transaction as to which the municipal advisor is providing advice.

Commenting on the Initial Draft Rule, Lewis Young stated that contingent fee arrangements benefit clients, particularly smaller municipal entities, because they allow municipal entity clients to finance the costs of the municipal advisor with the proceeds of the issuance. In their view, characterizing a contingent fee arrangement as a conflict of interest requiring disclosure to the client amounted to advising a client that the municipal advisor may not be acting in the client's best interest. They added that they believe the disclosure requirement would serve no useful purpose and could confuse clients. Sutherland stated that the Initial Draft Rule's required disclosure of contingent fee arrangements was duplicative of SEC Form MA [60] and, therefore, unnecessarily burdensome, and should be deleted.

Commenting on the Revised Draft Rule, Columbia Capital stated that the provision ''creates the appearance that the MSRB takes the position that one fee modality is less preferable to all others.'' Columbia Capital, Cooperman and Piper Jaffray commented that the proposed rule change should not single out one fee arrangement as being preferable to others. Columbia Capital, Cooperman and Piper Jaffray also contended that fee arrangements of any sort (hourly, fixed or non-contingent) create an adversarial relationship between the municipal advisor and its client. In Piper Jaffray's view, the potential conflicts of interest that are inherent in all fee arrangements are also ''generally knowable'' to both sides of a transaction and, therefore, the Revised Draft Rule's disclosure requirement would not be beneficial. Columbia Capital suggested deleting the provision.

WM Financial also expressed concerns regarding paragraph (b)(i)(F) of the Revised Draft Rule, but differed in its reasoning from Columbia Capital and Piper Jaffray. WM Financial disagreed with the premise that all fee structures create some conflict of interest. Rather, WM Financial stated that, because municipal advisors would be required to ''act in the best interest of their clients . . . good advice will prevent a fee arrangement from creating a 'conflict'.'' In their view, a ''conflict of interest does not exist when payment of fees is based on the success of services to be provided . . . .'' Like Lewis Young, WM Financial stated that contingent fees serve a valuable function because they allow small municipal entity clients to finance the cost of the municipal advisor with the proceeds from the issuance and ensure that the cost of the municipal advisor is only incurred after the successful completion of the issuance. WM Financial also requested that paragraph (b)(i)(F) be deleted.

The MSRB has considered the arguments and alternatives advanced by commenters and determined that requiring the disclosure of conflicts of interest arising from fee arrangements contingent on the size or closing of the transaction as to which the municipal advisor is providing advice is an appropriate and necessary measure to alert municipal entity and obligated person clients to the potential conflict of interest inherent in such fee arrangements. While the MSRB recognizes, as some commenters

[57] *See generally,* SEC Final Rule, 78 FR 67467.

[58] *See* 17 CFR 240.15Ba1–1(d)(2)(v). *See also* 15 U.S.C. 78*o*–4(e)(4)(C).

[59] *See* SEC Final Rule, 78 FR at 67529–32.

[60] *See* SEC Form MA, Items 4.H.–4.J.

pointed out, that other fee arrangements (such as hourly, fixed or otherwise non-contingent) might also give rise to conflicts, the MSRB believes that the potential harm to a client may be particularly acute if a client is not informed of a conflict of interest arising from a contingent fee arrangement. Furthermore, the MSRB does not agree with commenters that have argued that requiring a conflict of interest disclosure would suggest that the municipal advisor is not acting in the best interest of its client. The purpose of the disclosure requirement in proposed paragraph (b)(i)(F) simply would be to allow a municipal advisor's client to make an informed decision based on relevant facts and circumstances. Also, under the proposed rule change, municipal advisors would have the opportunity to provide a client with additional context about the benefits and drawbacks of other fee arrangements in relation to a contingent fee arrangement so that the client could choose a fee arrangement that serves its needs.

Disclosure of Conflicts of Interest to Investors

The MSRB received comments that called for the deletion of a provision set forth previously in the Revised Draft Rule as paragraph .08 of the Supplementary Material. Under the provision, if all or a portion of a document prepared by a municipal advisor or any of its affiliates were included in an official statement for an issue of municipal securities by or on behalf of a client of the municipal advisor, the municipal advisor would have been required to provide written disclosure to investors of any affiliation that would be a material conflict of interest under paragraph (b)(i)(B) of the Revised Draft Rule. The disclosure requirement also could have been satisfied if the relevant affiliate provided the written disclosure to investors.[61]

SIFMA supported deleting the disclosure requirement, noting that ''[m]unicipal advisors and their affiliates may have no contractual or other relationships (and in many cases have no form of privity) with investors, nor do they control the content of the Official Statement.'' SIFMA stated that it is the obligation of the issuer ''to make sure that its disclosure is materially accurate and complete'' and the responsibility of broker-dealers to comply with their obligations under applicable law. SIFMA observed that the municipal advisor is already required to provide the issuer with the same conflict disclosure under paragraph (b)(i)(B), arguing that the MSRB should leave the decision of whether to include such information in material distributed to investors to the issuer.

ICI and NABL also commented in favor of deleting the requirement. ICI provided comments similar to SIFMA's comments in response to both the Initial and Revised Draft Rules, but focused on how the required disclosure to investors would impact municipal advisors advising 529 plans. ICI supported requiring municipal advisors to disclose conflicts of interest to the municipal advisor's client but questioned why such information would be relevant to a person investing in 529 plan securities. ICI stated that if ''all material terms and conditions of the 529 plan offering already are disclosed in the offering document that is provided to investors and potential investors, this supplemental disclosure would not provide any additional protection to investors.'' In response to the First Request for Comment, NABL contended that requiring these disclosures would run contrary to the intent of the Dodd-Frank Act, which is to protect issuers. NABL suggested, as an alternative, that issuers be allowed to choose whether to disclose the conflicts of interest to investors.

The MSRB agrees with the commenters and notes that the provision could put municipal advisors in the impractical position of being required to make conflict of interest disclosures directly to investors or include the content of such disclosures in an issuer's official statement, although the municipal advisor may not have the authority or the means to do so. Moreover, because the proposed rule change would already require the municipal advisor to disclose all material conflicts of interest to the issuer, the MSRB believes the issuer will be well positioned to make the determination of whether to include such information in the official statement or other investor disclosure documents, consistent with the issuer's duties under all applicable law. In light of the comments and after a re-evaluation of the purpose and feasibility of the disclosure provision in the supplementary material as described above, the MSRB has deleted the provision.

Acknowledgment or Consent to Conflicts of Interest Disclosure

In response to the First Request for Comment, several commenters suggested differing approaches to the question of whether municipal advisors should be required to obtain some form of acknowledgment from their client of the conflicts of interest disclosures that municipal advisors are required to make under the proposed rule change.

In response to the First Request for Comment, NABL commented that the MSRB should follow the approach taken in the Model Rules of Conduct of the American Bar Association regarding the disclosure of conflicts of interest as stated in the Initial Draft Rule. NABL argued that municipal advisors should be required to obtain ''informed consent, confirmed in writing'' to each potentially waivable material conflict of interest. NABL stated that this standard is as appropriate for municipal advisors as it is for common law fiduciaries or attorneys. NABL suggested that the ''informed consent'' it advocated could be accomplished in several ways, including ''a writing evidencing an engagement, including a letter of intent, after disclosure to the client sufficient to establish informed consent.'' NABL contended that informed written consent from a municipal advisor's client is ''a necessary corollary to the requirement that an advisor disclose and provide sufficient detail about the nature of all material conflicts of interest.'' NABL also noted that informed consent confirmed in writing would be consistent with the requirements of the CFTC for commodity trading advisors. NAIPFA stated that it believed municipal advisors should be required to obtain an acknowledgment from their clients of the conflicts of interest that it has disclosed, saying that this would conform to the obligations of underwriters and other ''professionals possessing fiduciary duties.'' GFOA provided similar support for requiring an acknowledgment of the conflicts of interest disclosures from the municipal advisor's client but stated that, if such a requirement was added to the proposed rule change it would expect an explanation within the proposed rule change detailing how the acknowledgements of such conflicts relate to a municipal advisor's fiduciary duty.

In contrast to NABL, NAIPFA and GFOA, commenters including Cooperman, Lewis Young and Acacia commented that municipal advisors should not be required to obtain a written acknowledgment of disclosures

[61] Paragraph (b)(i)(B) of the Revised Draft Rule required written disclosure of ''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.''

before proceeding with the engagement. Cooperman stated that acknowledgement of conflicts of interest disclosures from municipal entity clients is an unnecessary and unjustified requirement that should be removed. Lewis Young stated that such written disclosure should not be required ''so long as the disclosures provided are not objected to by the client.'' Proposing a somewhat different approach, Acacia stated that municipal advisors should not be required to obtain a written acknowledgement of the conflicts disclosed but should be required to (i) provide such information (and record such provision), (ii) request receipt and consent but (iii) be permitted to proceed with a municipal advisory engagement in the absence of such receipt and consent if the municipal advisor has a reasonable belief that such information has been received. Acacia reasoned that its approach would be analogous to existing MSRB guidance for underwriters under MSRB Rule G–17.

The proposed rule change would not require a municipal advisor to obtain written acknowledgement from its client of the disclosure of conflicts of interest. While the MSRB understands the concerns expressed by commenters, the MSRB believes that the proposed rule change sufficiently obligates municipal advisors to ensure that their clients receive proper notice of material conflicts of interest. Proposed paragraph .05 of the Supplementary Material, for instance, would require municipal advisors to provide information sufficiently detailed to inform a client of the nature, implications and potential consequences of each conflict, and include an explanation of how the municipal advisor addresses or intends to manage or mitigate each conflict. Such disclosure would allow a municipal advisor's client to make an informed decision as to whether such conflicts can be adequately managed or mitigated. Furthermore, a municipal advisor's duty of care would require an advisor to have a reasonable basis for believing that its client received the disclosure and understood the nature, implications and potential consequences of the conflicts of interest that the municipal advisor disclosed. Further, the MSRB believes that obtaining some form of written acknowledgement from municipal entities and obligated persons would prove to be a significant procedural burden to both municipal advisors and their clients that would likely not result in a substantiated benefit.

Explanation of Mitigating Conflicts of Interest

As discussed above, proposed paragraph .05 of the Supplementary Material to Proposed Rule G–42, on conflicts of interest, would require a municipal advisor to include an explanation of how the municipal advisor would address, or manage or mitigate, the material conflicts of interest that it has disclosed to its client. In response to the Second Request for Comment, Sanchez challenged the value and purpose of this requirement by opining that municipal securities brokers and dealers are not subjected to the burden of making such disclosures. Sanchez requested that the MSRB revise the proposed rule change to require such disclosures only if requested by the client.

The MSRB has considered Sanchez's comments and determined not to amend proposed paragraph .05 of the Supplementary Material because the MSRB believes that the provision would serve a beneficial and protective function for clients. The municipal advisor's explanation would allow its client to adequately assess the potential effects the conflicts of interest could have on an engagement with the municipal advisor and to determine whether the actions the municipal advisor proposes to take to mitigate the conflicts of interest are sufficient and will not overly impair the quality and neutrality of the services to be performed by the municipal advisor.

Services for Conduit Issuers and Obligated Person Clients

Under subsection (e)(ii) of Proposed Rule G–42, a municipal advisor would be precluded from serving its municipal entity client as underwriter for a transaction directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing or has provided advice to the municipal entity.

In response to the Second Request for Comment, BDA commented that the proposed rule should explicitly allow a dealer/municipal advisor to serve as an underwriter for a conduit issuer and as a municipal advisor for the conduit borrower, even with respect to directly related matters.

Underwriting such a transaction would not be specifically prohibited by the ban on principal transactions in subsection (e)(ii) of Proposed Rule G–42, because it applies only in cases of municipal entity clients. A conduit borrower is typically not a municipal entity. Thus, depending on the specific facts and circumstances, this scenario could be permissible with appropriate disclosure and consent. Still, it is not clear that, even with disclosure and consent, such activity would be categorically consistent with all of the duties of a municipal advisor to an obligated person in all circumstances. Therefore, the MSRB has not amended the proposed rule as suggested by BDA.

Material Conflicts of Interest Required To Be Disclosed

Section (b) of Proposed Rule G–42 would include a non-exhaustive list of matters that would always constitute material conflicts of interest and that would be required to be disclosed by municipal advisors under the proposed rule change. Matters that must be disclosed as material conflicts of interest under section (b) include, among others: Any fee-splitting arrangements involving the municipal advisor and any provider of investments or services to the client; any payments made by the municipal advisor, directly or indirectly, to obtain or retain an engagement to perform municipal advisory activities for the client; any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice; and any legal or disciplinary event that is material to the client's evaluation of the municipal advisor or the integrity of its management or advisory personnel.

In response to the First Request for Comment, Lewis Young stated that the proposed rule should only require disclosure when an actual conflict of interest exists because providing tailored explanations of potential or hypothetical situations would be ''expensive, time consuming, and not very helpful.'' The MSRB disagrees and believes that the likely benefits from these disclosures will outweigh the cost associated with providing them to a municipal advisor's clients because the proposed rule change limits the required disclosure to only material conflicts of interest, both actual and potential, of which a municipal advisor is aware of after a reasonable inquiry. The MSRB also believes that requiring a municipal advisor to disclose conflicts of interest, actual and potential, that the municipal advisor becomes aware of after reasonable inquiry and that could reasonably be anticipated to impair the municipal advisor's ability to provide advice in accordance with the standards of conduct in section (a) of the rule, is necessary to provide clients with the requisite information to make an

informed decision regarding the selection of their municipal advisor.

ICI suggested adding prefatory language to section (b) that would clarify that a municipal advisor would be required to disclose only conflicts of interest that are applicable to its relationship with the specific client. ICI stated that adding such language would harmonize section (b) with the approach taken in the Investment Advisers Act regarding the delivery of brochures,[62] which it believed permits an investment adviser to omit ''inapplicable information'' from a disclosure it is required to provide to clients. The MSRB believes that Proposed Rule G–42 makes clear that municipal advisors are required only to make disclosure of material conflicts of interest and that this would exclude inapplicable information.

First Southwest expressed concern regarding the requirement of subsection (b)(i) that municipal advisors must provide written notice when they have no material conflicts of interest to disclose to their clients. First Southwest stated that the requirement would increase administrative requirements and provide little, if any, benefit in the event a conflict of interest were later discovered. The MSRB disagrees and believes that an affirmative written statement by the municipal advisor that it has no known material conflicts of interest would remove potential ambiguities about the completeness of the conflicts disclosure.

Sutherland commented that the conflicts of interest required to be disclosed would be duplicative of information that could be found in SEC Forms MA and MA–I and, therefore, would be unnecessary. As an example, Sutherland stated that SEC Form MA requires the disclosure of affiliated business entities; compensation arrangements; and proprietary interests in municipal advisor client transactions.[63] While some overlap could exist, the MSRB believes that the SEC forms do not solicit all of the information that would be required by the proposed rule change and, thus, would not serve as a sufficient substitute. Specifically, the SEC forms would not be a viable proxy for disclosing potential conflicts of interest that the municipal advisor could have, nor would the forms contain an explanation of how they intend to mitigate the material conflicts of interest that they disclose. The MSRB expects that the written disclosure of material conflicts of interest will be a useful tool to municipal advisor clients that will allow them to readily assess the impact of actual or potential conflicts of interest of potential or ongoing municipal advisory activities.

In response to the Second Request for Comment, SIFMA requested clarification regarding the standard for determining the materiality of the conflicts of interest described in paragraphs (b)(i)(A) and (G), and when disclosure is required. Under the Revised Draft Rule, paragraphs (b)(i)(A) and (G) required municipal advisors to disclose ''any . . . potential conflicts of interest . . . that might impair'' a municipal advisor's advice or its ability to provide advice in accordance with section (a) of Proposed Rule G–42. The language in these paragraphs concerned certain commenters, such as SIFMA, because they believed that such a standard would include nearly all imaginable conflicts of interest and result in overly broad disclosure that could distract from the provision's purpose. Therefore, to clarify, the MSRB has amended these paragraphs to state that disclosure is required, in paragraph (A) for ''any actual or potential conflicts of interest,'' and, in paragraph (G), for ''any other engagements or relationships.'' The MSRB believes that this revised language would more clearly establish a limiting, objective standard for disclosing certain conflicts of interest that would be relevant to a municipal advisor's client.

Further, paragraphs (b)(i)(A) and (G), as proposed, are revised to limit the disclosure of conflicts required under paragraphs (b)(i)(A) and (G) to those that potentially impact the advisor's ability to provide ''advice to or on behalf of the client in accordance with the standards of conduct of section (a) of this rule, as applicable.'' Previously, under the Revised Draft Rule, paragraphs (b)(i)(A) and (G) required a municipal advisor to provide disclosure of conflicts of interest that ''might impair its ability either to render unbiased and competent advice to'' its clients. This revision was made after re-evaluation of the phrasing used in the paragraphs and consideration of comments received from Sanchez. Sanchez stated that the use of the phrase ''unbiased and competent advice'' in the Revised Draft Rule ''. . . appear[s] to import the duty of loyalty and duty of care into the representations of obligated persons. . . .'' The MSRB agrees that the use of the phrasing ''unbiased and competent advice'' does not encompass all of the duties municipal advisors owe their clients, nor would it sufficiently differentiate between the standards of conduct owed by municipal advisors to their municipal entity clients and obligated person clients. The MSRB believes that the revised standard for identifying material conflicts of interest under proposed paragraphs (b)(i)(A) and (G) will more clearly reflect the standards of conduct in proposed section (a) and appropriately differentiate between municipal entity and obligated person clients.

In response to the Second Request for Comment, Sanchez also suggested a revision to clarify the last sentence of subsection (b)(i) of the Revised Draft Rule. Sanchez suggested deleting the term ''written documentation'' and using ''written statement'' instead to clarify for municipal advisors the action required to comply with subsection (b)(i). To remove any ambiguity, the MSRB has revised proposed subsection (b)(i) to clarify that, when appropriate, a municipal advisor must provide a ''written statement'' that the municipal advisor has no known material conflicts of interest.

Columbia Capital requested clarification regarding whether the disclosures required by the Revised Draft Rule may be made in more than one document. The required disclosures indeed may be provided to clients in more than one document, as long as the document and its delivery otherwise comply with the proposed rule. Because the language of the proposed rule is not to the contrary, the MSRB has not made any revisions in response to this comment.

FSR commented that use of the term ''indirectly'' in paragraph (b)(i)(B) in the Revised Draft Rule, which required disclosure of ''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,'' expanded the scope of the required disclosures unnecessarily and would make compliance difficult for a municipal advisor that is part of a large multi-service financial conglomerate. FSR believed that the Revised Draft Rule did not provide municipal advisors with sufficient guidance to identify activity that could be indirectly related to municipal advisory activities, and, taken in its plain meaning, could lead to a substantial burden on firms having numerous affiliates that provide a wide array of services. After further consideration of the purpose and intent of the proposed paragraph, the MSRB has removed the clause ''or indirectly.'' The MSRB believes revised proposed paragraph (b)(i)(B) will provide the

[62] *See* 17 CFR 275.204–3.

[63] *See* SEC Form MA, Items 1.K., 4.H.–4.J. and 7.A.–7.F., respectively.

appropriate notice to clients of the relationships of any affiliates of the municipal advisor that are likely to present material conflicts of interest.

Disclosure of Legal or Disciplinary Events

Several commenters addressed the draft requirements to disclose legal or disciplinary events. FSR commented that subsection (b)(ii) of the Revised Draft Rule would require a separate written disclosure of legal or disciplinary events that is redundant of the requirements of subsection (c)(iii) of the Revised Draft Rule. FSR requested that ''these disclosure requirements be deemed satisfied if an advisor provides information about where clients may access electronically the advisor's most recent [SEC] Forms MA and MA–I, along with the date of the last material amendment to any legal or disciplinary event disclosure on such forms.'' SIFMA, in response to the Second Request for Comment, similarly stated that requiring ''[duplicative] disclosure of specific events that are already disclosed in [SEC] Forms MA and MA–I provides little, if any, benefit to municipal entities or obligated persons, while it imposes unnecessary additional burdens on municipal advisors.'' SIFMA suggested that providing clients with the information regarding how to obtain electronic access to a municipal advisor's legal and disciplinary history on SEC Forms MA and MA–I should suffice. Sanchez stated, regarding the Revised Draft Rule, that ''[t]his requirement appears to be overly burdensome . . . , [and] it should be sufficient for purposes of this rule that a municipal advisor be required to direct clients to their EDGAR filings by providing clients with sufficiently specific information to locate their EDGAR filings.'' [64]

The MSRB contemplated that municipal advisors would be able to satisfy their disclosure of legal and disciplinary events under sections (b) and (c) of the Revised Draft Rule with specific reference to the relevant portions of their most recent SEC Forms MA or MA–I filed with the Commission. Proposed Rule G–42(b)(ii) further clarifies this intention, and requires the municipal advisor to provide detailed information specifying where the client may electronically access such forms. The MSRB believes this approach will address the issue of duplicative disclosure of the disciplinary and other legal events contained in SEC Forms MA and MA–I. This revision also clarifies that municipal advisors may satisfy the disclosure requirements of subsections (b)(ii) and (c)(iii) in a similar fashion.

A municipal advisor could, conceivably, simultaneously satisfy the requirements of proposed subsections (b)(ii) and (c)(iii) in one document if it were provided to the client prior to or upon engaging in municipal advisory activities for the client. However, if combined written disclosure and relationship documentation were made after a municipal advisor engages in municipal advisory activities, the municipal advisor would only be in compliance with proposed subsection (c)(iii) and not subsection (b)(ii).

SIFMA also suggested that subsection (c)(iv) of the Revised Draft Rule should be removed. The subsection would require municipal advisors to document the date of the last material change, including any addition, to the legal or disciplinary event disclosures on any SEC Form MA or MA–I filed with the Commission. Specifically, SIFMA believed that requiring municipal advisors to update their written disclosures and documentation with each of their municipal advisory clients whenever a material change to a legal or disciplinary event was made to any SEC Forms MA or MA–I would be unjustified.

Proposed section (c) requires the documentation of the municipal advisory relationship to be promptly amended or supplemented to reflect any material changes or additions, and requires the amended documentation or supplement to be promptly delivered to the municipal entity or obligated person client. However, the MSRB does not believe the update requirement under proposed section (c) is overly burdensome because municipal advisors need only provide the date of the last material change, including any addition, to their legal or disciplinary event disclosure to their clients, as they would be permitted to reference their SEC Forms MA and MA–I for the details of such material changes. Additionally, the required documentation of the municipal advisory relationship could be satisfied through the use of more than one writing and updates or amendments to such documents could be additional, separate writings that either amend or supplement earlier writings. The MSRB believes these accommodations sufficiently address the concern that municipal advisors would be required to amend and redistribute a single writing every time a material change or addition needed to be included. Further, the MSRB believes that, by requiring municipal advisors to update the written documentation relating to legal or disciplinary event disclosures provided to municipal entities and obligated persons, proposed subsection (c)(iv) would help ensure that those clients have sufficient, accurate and current information to better inform their decisions to engage and/or continue engaging a municipal advisor. The MSRB notes that the requirements of proposed section (c) must be made in writing and delivered to the municipal advisor's client in accordance with the duty of care and, as applicable, the duty of loyalty.

Coastal, Kutak and Parsons objected to the Initial Draft Rule's requirement to disclose the legal and disciplinary events for all individuals at a municipal advisory firm for which the firm is required to submit an SEC Form MA–I. They suggested that municipal advisors should not be required to disclose to a client legal and disciplinary events that relate to an individual that is employed by the municipal advisor, if that individual is not a part of (or reasonably expected to be a part of) the advisor's team working for the client. Although there could be numerous municipal advisors with large numbers of employees, as Coastal indicated, the MSRB believes there is insufficient cause to narrow the requirement of this disclosure obligation. Specifically, the MSRB notes that, although all of a municipal advisor's employees might not be a part of the team working on a particular client matter, the number of employees with legal or disciplinary events that a municipal advisor employs and the nature of any past legal or disciplinary events related to those employees could be material to the client's evaluation of the municipal advisor or the integrity of its management or advisory personnel. In any event, since a municipal advisor could satisfy Proposed Rule G–42(b)(ii) and (c)(iii) by providing information specifying where the client can electronically access SEC Forms MA and MA–I, there would be little additional burden imposed on municipal advisors by leaving the scope of these requirements unchanged.

[64] In response to the First Request for Comment, Sutherland suggested that there is sufficient disclosure about disciplinary history provided in a municipal advisor's SEC Forms MA and MA–I filed with the SEC, and Parsons stated that disclosure should not be required in the rule given such public disclosure on those forms. Similarly, Lewis Young and NAIPFA believed the disclosure of legal or disciplinary events would be duplicative and unnecessarily burdensome and also suggested that municipal advisors should be able to satisfy the requirement by referencing SEC Forms MA or MA–I.

Type of Writing(s) Required To Document the Municipal Advisory Relationship

Several commenters discussed the matter of documenting the municipal advisory relationship and the type of writing that should be required to evidence the municipal advisory relationship between the municipal advisor and its client.

FLA DBF, correctly recognizing that the Revised Draft Rule's reference to a ''writing'' does not require a written contract, suggested that the proposed rule change should be amended to require municipal advisors to enter into written contracts with their municipal entity clients regarding their municipal advisory relationships. In contrast, GFOA, while also correctly recognizing that the Revised Draft Rule does not require a written contract, supported the absence of a contract requirement. GFOA noted that although entering into a bilateral contract is a GFOA best practice, ''there may not always be a need for a specific contract.'' GFOA agrees with the MSRB that the municipal advisory relationship should be stated in writing as it would allow the issuer to clearly delineate the scope of work it intends its municipal advisor to provide.

A number of other commenters, including ABA, BDA, ICI, Lewis Young, MSA, NAIPFA and SIFMA, however, construed section (c) of the proposed rule as requiring a written contract, leading them to raise various concerns about the proposed rule applying to existing contracts that might need to be revised. As a result, these commenters suggested the inclusion of various kinds of transitional rule provisions to address these issues. ABA and Lewis Young, for example, requested a transitional provision to permit advisors to honor their existing agreements with their clients until they expire. ICI recommended that the MSRB clarify that, if approved, Proposed Rule G–42 would only apply prospectively. SIFMA requested that the MSRB limit or eliminate the need for municipal advisors to re-document their municipal advisory relationships and apply the disclosure requirements of the proposed rule only to future agreements. MSA requested guidance on whether the obligations of section (c) of Proposed Rule G–42 could be satisfied by a contract (such as a Master Services or Professional Services Agreement) between the municipal advisor and its client.

The documentation requirement of section (c) of Proposed Rule G–42, as with the Revised Draft Rule, would not require the creation of new contractual relationships or the modification of existing contracts or agreements between municipal advisors and their clients. The purpose of the requirement is to help ensure that certain terms of each municipal advisory relationship would be reduced to writing and delivered to the municipal advisor's municipal entity or obligated person client. So long as the content of the documentation adheres to the requirements of the proposed rule (including the standards of conduct in section (a)), municipal advisors and their clients have some latitude in deciding the exact form the documentation and writing might take. If municipal advisors have already delivered documentation meeting some or all of the requirements of proposed section (c), then municipal advisors would be able to rely on such documents to satisfy some or all of their obligations under section (c). While certainly permitted, the proposed rule would not require municipal advisors to enter into written contracts with their municipal entity or obligated person clients and municipal advisors could satisfy the requirements of provision (c) by providing separate or supplemental documents to any preexisting contract, agreement or writing previously provided that might be in place between the municipal advisor and its client. The relevant part of proposed section (c) has been further revised to delete the phrase ''enter into'' (which could have connoted the formation of a contract) and reads as follows: ''A municipal advisor must evidence each of its municipal advisory relationships by a writing or writings created and delivered to the municipal entity or obligated person client prior to, upon or promptly after the establishment of the municipal advisory relationship.'' The MSRB believes that requiring the documentation to take the form of a bilateral contract would be unnecessary and could lead to some of the burdensome consequences identified by commenters. The amendments to the Revised Draft Rule should clarify that municipal advisors would not be required to alter or re-execute any existing contract and that, in the future, the documentation and disclosure requirements could be satisfied in writings that are either included in a contract or separate and independent of any contract entered into between the municipal advisor and its municipal entity or obligated person client.

In response to the First Request for Comment, BDA and GKB stated that they generally supported the documentation and disclosure requirements of section (c) of the Initial Draft Rule but believed, with respect to municipal financial products, that a ''written agreement'' (as they believed was required by section (c)) should only be required when municipal advisory activities are engaged in for compensation. Based on their comments, it appears that BDA and GKB understood section (c) to implicitly require the municipal advisor and its client to evidence their municipal advisory relationship with a bilateral contract. NAIPFA, in its response to the Initial Draft Rule, asked the related question: ''Does this mean that the writing must be a two party agreement?'' NAIPFA also suggested that the MSRB amend section (c) to allow municipal advisors to satisfy the requirements of the section through an engagement letter. As previously stated, section (c) would not require, or preclude the use of a bilateral contract or engagement letter to evidence the municipal advisory relationship. So long as the content adheres to the requirements of Proposed Rule G–42 (including the standards of conduct of section (a)), municipal advisors and their clients would have some latitude in deciding the exact form the documentation and writings might take.

NAIPFA expressed concerns regarding the amount of information that would be required to be included in the documentation required by section (c), stating that municipal advisors would be put at a ''significant competitive disadvantage to their [underwriting] counterparts . . . [because] underwriters are not mandated to include any particular contract-related terms within their engagement letter, such as clauses relating to the termination of the relationship or their obligations relating to certain aspects of the transaction . . . .'' The MSRB does not believe the proposed documentation requirement would result in the competitive disadvantages described by NAIPFA. First, underwriters are required to make similar disclosures to issuers of municipal securities under MSRB's fair dealing rule, Rule G–17, which includes certain disclosures regarding the underwriter's compensation. Second, to the extent any of the requirements of section (c) are included in a written agreement, contract, engagement letter or similar document already in possession of the client, such information would not need to be included in a separate writing delivered to the municipal advisor's client. Instead, municipal advisors would be

able to supplement existing writings to comply with section (c). Finally, because a municipal advisor generally would be prohibited from acting as an underwriter for a transaction directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing or has provided advice, the MSRB believes it would be unlikely that a municipal advisor would be in direct competition with an underwriter as suggested by NAIPFA.

In response to the Initial Draft Rule, ICI suggested that section (c) be revised to specify that only material changes to the information provided in the documentation required by section (c) would trigger the updating requirement. The MSRB did not intend by section (c) to require the supplementation of immaterial information and section (c) of the proposed rule has been revised to provide this clarification.

Triggering the Documentation Required by Section (c)

Under the Initial Draft Rule, a municipal advisor would have been required to 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. In response to the First Request for Comment, Northland commented that section (c) of the Initial Draft Rule should require that the documentation be in place prior to engaging in municipal advisory activities rather than being permitted to be created and provided subsequently (*i.e.,* after the establishment of a municipal advisory relationship (as defined by the Initial Draft Rule)). Northland opined that its approach would align the proposed rule change with analogous requirements and principles of the SEC Final Rule. Northland also argued that earlier documentation of the municipal advisory relationship is warranted for the same reasons it believes justify the proposed rule change's requirement to disclose conflicts of interest upon or prior to engaging in municipal advisory activities. The MSRB has considered when municipal advisors should be required to document their relationship with their clients and determined that documentation should only be required after both parties have agreed that the municipal advisor would engage in municipal advisory activities for or on behalf of the client. It is understood by the MSRB that a municipal advisor could engage in municipal advisory activities while seeking an engagement to perform municipal advisory activities but then might ultimately not be engaged by the client. Also, in some instances, a municipal advisor could be called upon to engage in municipal advisory activities on behalf of its client on short notice for a time-sensitive matter. In such scenarios, the MSRB does not believe it would be appropriate, or necessary, to require documentation of the municipal advisory relationship because, as with the first case, there is a reasonable possibility that no municipal advisory relationship would materialize and, with regard to the second, the MSRB does not want to inhibit a municipal advisor from performing its municipal advisory activities for municipal entities and obligated persons when time is short and documenting the municipal advisory relationship might not be feasible. The MSRB believes that, when balanced against the potential benefits of requiring earlier documentation of the municipal advisory relationship, the timely disclosure of material conflicts of interest (in accordance with section (b) of Proposed Rule G–42) will sufficiently mitigate the potential consequences identified by Northland and will serve as sufficient protection to a municipal advisor's client to make an informed decision about whether to accept the advice provided by the municipal advisor until such time that documentation containing the information required by section (c) can be created and delivered.

On a separate but related matter, Northland stated that the use of the term ''municipal advisory relationship'' would likely lead to confusion between how Northland believes the term is used by municipal advisors and other industry participants and how the term had been defined for purposes of the Initial Draft Rule. Northland believed that it would be difficult for municipal advisors to parse apart and document ''municipal advisory relationships'' when some of those relationships are ''historical and ongoing'' and are rarely thought of as separate relationships. The MSRB believes that the definition provided in Proposed Rule G–42(f)(vi) would provide sufficient guidance to municipal advisors in this regard. That provision would state that a municipal advisory relationship is deemed to exist when a municipal advisor enters into an agreement to engage in municipal advisory activities for a municipal entity or obligated person and ends on, the earlier of, the date on which the municipal advisory relationship has terminated pursuant to the terms of the documentation of the municipal advisory relationship, or the date on which the municipal advisor withdraws from the municipal advisory relationship.

In response to the Second Request for Comment, Piper Jaffray, while generally supportive of the documentation requirement of section (c) of the Revised Draft Rule, expressed concern that it could require premature documentation of a municipal advisory relationship. Specifically, Piper Jaffray stated that section (c) could require documentation when the municipal advisor has not been selected by its client to be its municipal advisor and, instead, is, in fact, engaging in municipal advisory activities as a means to obtain the engagement with the client to perform municipal advisory activities. Section (c) of the Revised Draft Rule, however, explicitly stated that the documentation requirement would only be triggered ''prior to, upon or promptly after the establishment of the *municipal advisory relationship''* (emphasis added). As defined in subsection (f)(vi), a municipal advisory relationship would only be deemed to exist when the ''municipal advisor enters into an agreement to engage in municipal advisory activities for a municipal entity or obligated person.'' Thus, Proposed Rule G–42 would not necessarily require the provision of relationship documentation during an early stage of municipal advisory activities when the municipal advisor is still pursuing an engagement to perform municipal advisory activities.

Other Comments Regarding the Documentation Requirement

Consolidation. In response to the Revised Draft Rule, Piper Jaffray suggested that the disclosure and documentation requirements of sections (b) and (c) could be more clearly established if the sections were merged. In particular, Piper Jaffray found it confusing that a municipal advisor providing ''advice,'' but that has not yet been engaged by an issuer, must provide disclosures related to its compensation under paragraph (b)(i)(F). Piper Jaffray then posed the question: ''[I]s the intention of the [MSRB] to assure that municipal advisors must provide conflicts disclosure when providing information that would constitute 'advice' prior to [being] engaged[?]'' Piper Jaffray suggested that the intention and purpose of the proposed rule change could be better served if the required disclosures and documentation of the municipal advisory relationship were provided when the advisor is selected by the issuer to provide it with advice.

The MSRB has considered Piper Jaffray's recommendation to merge

sections (b) and (c) and modify the timing of the disclosure requirement, but believes such amendments would conflict with the intention of having municipal advisors disclose conflicts of interest upon or prior to engaging in municipal advisory activities for the client. Combining the paragraphs could cause municipal advisors to delay making the proposed rule's required disclosures until the municipal advisory relationship has been reduced to writing, which could be a significant amount of time after the client has received, and potentially acted on, advice from the municipal advisor. For these reasons, the suggested changes are not included in Proposed Rule G–42.

Indirect Compensation and Treatment of Incidental Informal Advice. Regarding the documentation of the municipal advisory relationship, SIFMA requested that Proposed Rule G–42 include a definition of ''indirect compensation'' as it is used in subsection (c)(i). On a related topic, SIFMA requested that the MSRB ''clarify that informal advice that is incidental to providing brokerage/securities [services] would not, alone, trigger a written documentation requirement under [section (c) of the Revised Draft Rule] . . . .''

The MSRB believes that additional clarification within the proposed rule change is not necessary because the phrase ''indirect compensation'' is widely used and understood in the municipal advisory and securities industry and is well established in securities statutes and jurisprudence. Providing a definition of ''indirect compensation'' within Proposed Rule G–42 might reduce clarity regarding the general understanding of the phrase and lead to unnecessary confusion in an instance where sufficient guidance is already available.

Regarding SIFMA's request pertaining to advice that is incidental to providing brokerage/securities services, the MSRB notes that the proposed rule change would apply to a scope of municipal advisory activities as defined in the SEC Final Rule. Whether certain activities constitute ''advice'' under the SEC Final Rule is a legal interpretation within the authority of the SEC, and not the MSRB, to make.

Recommendations and Review of Recommendations of Other Parties

Section (d) of Proposed Rule G–42 would provide that if a municipal advisor makes a recommendation of a municipal securities transaction or municipal financial product to its client, the municipal advisor must determine, based on the information obtained through reasonable diligence, whether the transaction or product is suitable for the client. Section (d) also would contemplate that a municipal advisor could be asked to evaluate a recommendation made to its client by another party, such as a recommendation by an underwriter of a new financing structure or a new financial product. Section (d) would require municipal advisors to conduct a suitability analysis—when requested by the client and within the scope of the engagement—of the recommendations of these third parties, guided by the requirements and principles contained in relevant portions of the supplementary material (such as paragraphs .01, .08 and .09).

Commenters raised a number of issues with section (d) of Proposed Rule G–42 (sections (d) and (e) of the Initial Draft Rule) and the related paragraphs .01 (Duty of Care), .08 (Suitability) and .09 (Know Your Client) of the Supplementary Material to Proposed Rule G–42. Below is a summary of, and response to, these comments.

General Comments Regarding Section (d)

In response to the Second Request for Comment, NAIPFA and GFOA expressed their general support for the Revised Draft Rule's suitability standard of section (d) of Proposed Rule G–42. NAIPFA believed it appropriately reflects a municipal advisor's fiduciary duties to its municipal entity clients.

Compliance and Examination. BDA, in response to the Second Request for Comment, expressed its support of the Revised Draft Rule's requirement to have municipal advisors review recommendations of other parties, but requested specific guidance on how municipal advisors would develop reasonable policies to comply with section (d). BDA also expressed concern about how FINRA examiners would test a dealer's compliance with the requirements of section (d) when serving as a municipal advisor.

The MSRB believes it has provided sufficient guidance to municipal advisors about the principles and requirements that should inform, and be incorporated in, a municipal advisor's policies and procedures by identifying the matters in the proposed rule text (such as in subsections (d)(i)–(iii) and paragraphs .01, .08 and .09 of the Supplementary Material) that a municipal advisor must, as applicable, consider when forming its advice or recommendation. The MSRB recognizes the diversity of the population of municipal advisors and the municipal advisory activities in which they engage in and believes the primarily principles-based approach taken by the proposed rule change will accommodate that diversity. The MSRB also believes this approach will clearly establish the minimum requirements and principles, which financial regulators could then consistently apply in their examination of municipal advisors.

Updating Recommendations. In response to the Second Request for Comment, SMA requested that the MSRB clarify that the suitability of a recommendation would be determined by the facts and circumstances at the time a client enters into the municipal securities transaction and that the municipal advisor should not have continuing responsibility to update its determination.

The MSRB believes that whether advice given or recommendations made by municipal advisors would need to be updated would depend on the facts and circumstances surrounding the advice and recommendation, including, but not limited to, the scope of the services that the municipal advisor agreed to provide its client. The MSRB believes that the reasonableness of a municipal advisor's recommendation or advice would be determined by considering the information relied upon by, and available to, the municipal advisor at the time the recommendation is made or advice is given to its client. However, over the course of an ongoing municipal advisory relationship, it is possible that a municipal advisor would, as part of its duty of care, need to apprise its client of changes to the suitability of the advice or recommendation it had previously given. In such cases, a municipal advisor's responsibilities would depend upon the facts and circumstances and the parameters of its municipal advisory relationship. The MSRB believes that the proposed rule change will provide municipal advisors with the requisite guidance to comply with its requirements.

Third-Party Recommendations. Lamont and First Southwest, in response to the First Request for Comment, requested clarification regarding whether a municipal advisor must review any third-party recommendation related to the advice that the municipal advisor has agreed to provide.

Proposed Rule G–42 would require municipal advisors to review a third-party recommendation when such a review is within the scope of the engagement between it and its client or if such a review would be part of the reasonable diligence required to reasonably determine whether a recommendation or advice is suitable

for its client. Therefore, a municipal advisor's obligation to review third-party recommendations would depend on the facts and circumstances of each particular instance. The MSRB believes that section (d) and the relevant portions of the supplementary material of the proposed rule change will provide sufficient guidance to municipal advisors presented with such scenarios.

Informing Client of Matters Related to Review of Recommendation. In response to the First Request for Comment, Northland commented that the Initial Draft Rule's requirement that municipal advisors must, under section (d), *discuss* matters such as the material risks of a recommendation and the basis upon which the municipal advisor reasonably believes its recommendation is suitable for its client would encourage written documentation of such discussions and create the potential for conflict between the information provided by the municipal advisor and the actions ultimately taken by the client. It appears that Northland's concern is that a municipal advisor could be exposed to liability in an *ex post* review of its suitability analysis.

The MSRB received other comments related to the Initial Draft Rule's requirement that municipal advisors must *discuss* these matters with their clients. In response, the Revised Draft Rule included a modification that required municipal advisors to *inform* their clients of the matters specified in proposed section (d). The modification was made to grant some flexibility to municipal advisors in the manner in which the matters are delivered to their clients. The MSRB understands that a municipal advisor's client could elect to engage in a course of action that deviates from the municipal advisor's recommendation. For purposes of compliance with section (d), however, a client's decision to disregard its municipal advisor's recommendation would alone have no bearing on whether the municipal advisor conducted an adequate analysis of the recommendation it provided. An examination for compliance with section (d) would focus on the adequacy of the suitability analysis provided by the municipal advisor, not whether the client ultimately pursued the municipal advisor's recommendation.

Limiting Duty to Review Recommendations of Others. In response to the First and Second Request for Comment, NAIPFA stated that, when a municipal entity or obligated person has engaged an independent registered municipal advisor [65] and is also obtaining advice from a third party that is relying upon the independent registered municipal advisor exemption from the SEC registration requirement [66] to provide advice to the municipal entity or obligated person, the independent registered municipal advisor should not be permitted to limit the scope of the engagement with its client so as not to include the review of recommendations made by the third-party.

The MSRB has considered, yet disagrees with, NAIPFA's position. The MSRB believes that municipal advisor clients, with the agreement of the municipal advisor, should be able to define the scope of their municipal advisory relationships and thus determine what services the municipal advisor will provide. Furthermore, requiring municipal advisors to review all third-party recommendations could result in a costly burden to municipal entities and obligated persons that do not expect to derive sufficient value from such review. However, the MSRB acknowledges that limiting the scope of the engagement between a municipal entity or obligated person and its independent registered municipal advisor could affect a third party's ability to qualify and make use of exemptions discussed in the SEC Final Rule, including the exemption mentioned by NAIPFA.[67]

Request for Definition of ''Independent'' as Used in Paragraph .03 of the Supplementary Material

BDA, in response to the First Request for Comment, requested that the MSRB define the term ''independent'' for purposes of paragraph .03 of the Supplementary Material, action independent of or contrary to advice, to the Initial Draft Rule. Proposed paragraph .03 states that a municipal advisor would not be required to disengage from a municipal advisory relationship if its client were to elect a course of action that is ''independent or contrary'' to the advice provided by the municipal advisor. BDA asked if ''independent'' would mean that the municipal advisor's client is not relying on or considering the advice of the municipal advisor; that the client is not seeking advice from the municipal advisor; or, that the client is acting contrary to advice given by the municipal advisor.

Proposed paragraph .03 of the Supplementary Material was designed to address instances when a municipal advisor's client has decided either not to accept, rely on or consider the municipal advisor's advice or to take an approach or position that varies (completely or partially) from advice provided by the municipal advisor. In the event of such occurrences, paragraph .03 would allow a municipal advisor to continue in its advising capacity so long as doing so would not otherwise be precluded by MSRB rules or federal, state or other laws, as applicable.

Scope of the Recommendations Analysis. Proposed section (d) and paragraph .08 of the Supplementary Material address municipal advisors' recommendations of municipal securities transactions or municipal financial products. However, as part of the duty of care articulated under proposed paragraph .01 of the Supplementary Material, a municipal advisor would be required to have a reasonable basis for any advice provided to its client.

Northland requested clarification regarding whether section (d) of the Initial Draft Rule would be applicable to all recommendations provided by the municipal advisor or only when a recommendation is related to entering into a municipal securities transaction or municipal financial product. NABL stated, in response to the First Request for Comment, that ''suitability,'' as a general matter, is a regulatory concept that could not be appropriately applied to municipal advisors in all instances. NABL suggested that a municipal advisor should be permitted to make a recommendation as to a limited aspect of the transaction, even if the municipal advisor does not agree that the transaction is suitable.

Section (d) of Proposed Rule G–42 would provide that a municipal advisor must not recommend that its client enter into any municipal securities transaction or municipal financial product unless the municipal advisor has determined, based on the information obtained through the reasonable diligence of the municipal advisor, whether the transaction or product is suitable for the client. A municipal advisor could provide advice regarding an aspect of a municipal securities transaction or municipal financial product that the municipal advisor believes to be unsuitable for its client so long as the municipal advisor adhered to the duty of care, duty of loyalty, and all other laws, as applicable, and either did not recommend the unsuitable transaction

[65] *See* SEC Rule 15Ba1–1(d)(3)(vi) (17 CFR 240.15Ba1–1(d)(3)(vi)). ''Independent registered municipal advisor'' is defined in SEC Rule 15Ba1–1(d)(3)(vi)(A) (17 CFR 240.15Ba1–1(d)(3)(vi)(A)).

[66] *See* SEC Rule 15Ba1–1(d)(3)(iv) (17 CFR 240.15Ba1–1(d)(3)(iv)).

[67] 17 CFR 240.15Ba1–1.

or product or informed the client of the basis on which the municipal advisor reasonably believed the transaction or product to be unsuitable.

Documenting Recommendations. Lewis Young expressed concern that section (d) of the Initial Draft Rule would require excessive and ''defensive'' recordkeeping and documentation in order to evidence compliance with the section's requirement that municipal advisors inform their clients of certain matters pertaining to their recommendations. Lewis Young argued that such documentation would be a ''waste of time and resources'' because the client has already determined to pursue a particular municipal securities transaction or municipal financial product. Accordingly, Lewis Young believed documenting such discussions ''so as to have a 'good answer' for the next regulatory audit'' would be overly and unnecessarily burdensome.

The MSRB believes that the proposed rule change sufficiently articulates that municipal advisors and their clients would have the discretion to define the parameters of their municipal advisory relationship and, thus, decide between them what municipal advisory activities would be performed by the municipal advisor for its client, including what matters for which a municipal advisor would be providing advice. As such, regarding the scenario proffered by Lewis Young, a municipal advisor that has not been engaged to provide advice about a municipal securities transaction or municipal financial product that was previously selected by its client would not be under an implicit obligation to provide the client with the suitability analysis described in proposed section (d) and the supplementary material. The municipal advisor would remain subject to (among other provisions of the proposed rule change) a duty of care, duty of loyalty (as applicable) and relevant supplementary material such as paragraphs .04 (Limitations on the Scope of the Engagement) and .09 (Know Your Client). Further, the MSRB believes that the documentation required by proposed Rule G–8(h)(iv) is an appropriately tailored recordkeeping requirement that will assist regulatory examiners in assessing the compliance of municipal advisors with the proposed rule change. Also, the MSRB believes the recordkeeping requirements will not be overly burdensome because municipal advisors would only be required to maintain documents created by the municipal advisor that were *material* to its review of a recommendation by another party or that memorializes the basis for any conclusions as to suitability.

Recommendations of Investment Funds. NY State Bar requested the MSRB to clarify the obligations owed by a municipal advisor to its client when the recommendation is to invest in an investment fund that is managed by a third-party advisor. NY State Bar's concern was that, under the Initial Draft Rule, a municipal advisor would be obligated to provide a recommendation, and therefore a suitability analysis, of the investment choices made by the manager of the investment fund.

Depending on the facts and circumstance of a particular scenario, such as described by NY State Bar, a municipal advisor could have a multitude of different obligations regarding its recommendation of an investment fund to a client. While the proposed rule change would allow municipal advisors and their clients to negotiate the municipal advisory activities to be performed, the standards of conduct articulated in section (a) and the relevant paragraphs of the supplementary material would not be subject to alteration. Therefore, a municipal advisor that has agreed to provide a recommendation regarding the investment in an investment fund would be required to exercise a duty of care that could, in turn, require the municipal advisor to conduct a suitability analysis that might, depending on the relevant facts and circumstance of a particular instance, require the municipal advisor to conduct a suitability analysis of the investment choices made by the manager of the investment funds. By establishing the applicable standards of conduct for municipal advisors, and providing additional guidance regarding those standards in the supplementary material to Proposed Rule G–42, the MSRB believes that municipal advisors will be able to make a determination regarding what actions they must undertake when making recommendations to clients.

Prescriptive Metrics for Suitability Analysis. In response to the First Request for Comment, MSA asked whether the MSRB would provide the ''specific metrics (standard debt issuance options)'' that should be used to determine the suitability of a recommendation. MSA also inquired into whether ''there [will] be standards set for this quantitative review or will it be the responsibility of the individual [municipal advisor] to define the suitability metrics based on the unique circumstances of each client or project?''

In order to accommodate the diversity of the municipal securities and municipal advisory marketplace, the MSRB has taken a primarily principles-based approach regarding the required suitability analysis so that municipal entities and obligated persons would receive appropriately tailored and relevant advice and recommendations from their municipal advisors. For this reason, the MSRB does not intend to provide the specific metrics requested by MSA and instead will rely upon the principles and requirements provided by the proposed rule change.

Municipal Advisor Reliance on Information Provided by Client

A number of commenters voiced apprehension regarding what they believed to be the high standard set for providing recommendations to their clients or reviewing the recommendation of a third party. Specifically, commenters expressed concern with the portion of paragraph .01 (which would be applicable to recommendations contemplated under section (d)) that would require a municipal advisor to ''undertake a reasonable investigation to determine that it is not basing any recommendation on materially inaccurate or incomplete information.'' Most commenters stated that a municipal advisor should be able to rely on the accuracy and veracity of the information provided by a client and not be required to validate such information.

Sutherland asked, in response to the First Request for Comment, in the context of 529 plans, what the Initial Draft Rule would require a municipal advisor to do in order to satisfy the proposed obligation to undertake a reasonable investigation to determine that it is not basing any recommendation on materially inaccurate or incomplete information. Sutherland also asked whether a municipal advisor must obtain a representation from the issuer that the information it provides does not contain any material misstatements or omissions.

In response to the Second Request for Comment, ICI stated that municipal advisors to 529 plans should not be required to verify the veracity or completeness of the information provided to them by persons who are authorized by the municipal entity client to act on behalf of a state's 529 plan.

NABL commented that a municipal advisor should be free to recommend a transaction based on facts given to it by its client, without exercising any diligence to check the facts, if consistent with the scope of the engagement with

its client. Regarding the review of recommendations of others, MSA asked whether it would be necessary to obtain documentation or information used by a third-party to make a recommendation that the municipal advisor has been engaged to review. MSA believed that the Initial Draft Rule should require the third party, who provided the recommendation and that the municipal advisor has been engaged to review, to disclose any documentation relied upon for that recommendation.

The duty of care is a core principle underlying many of the obligations of the proposed rule and is included, among other reasons, to ensure municipal entities and obligated persons are shielded from the potential negative consequences that could result from not receiving well-informed advice and expertly-executed services from their municipal advisors. The MSRB believes that requiring municipal advisors to conduct a reasonable investigation about the accuracy and completeness of the information, including information pertaining to a 529 plan, on which they will be basing their advice is necessary to ensure that clients will be able to make an informed decision based on facts and choose a prudent course of action. As stated in section (d), the municipal advisor would only need to exercise reasonable diligence, thus obviating the need for a municipal advisor to go to impractical lengths to determine the accuracy and completeness of the information on which it will be basing its advice and/or recommendation. The MSRB believes that obtaining a representation from the municipal advisor's client that the information it has provided, with no or insufficient diligence conducted by the municipal advisor, would not satisfy either section (d) or paragraph .01 of the Supplementary Material of Proposed Rule G–42 because such a representation would not sufficiently preclude the potential for the risks associated with providing advice or recommendations without a reasonable inquiry into the accuracy and completeness of the information upon which such advice or recommendations are based. While alone, such a representation would not satisfy the requirements of the proposed rule change, a municipal advisor would be free to seek and obtain such a representation as a prudent part of its process for conducting a reasonable investigation of the veracity and completeness of the information on which it is basing its recommendation.

Applicability of Suitability Analysis to 529 Plans

Several commenters raised concerns about how section (d) and the related supplementary material that address suitability analysis would generally apply to municipal advisors advising 529 plans.

ICI stated, in response to the Second Request for Comment, that the suitability standard set forth in paragraph .08 of the Supplementary Material should recognize what ICI believes to be differences between advice rendered in connection with municipal securities, generally, and that rendered in connection with 529 plans. Sutherland voiced concerns in its response to the First Request for Comment and stated that the suitability factors listed in paragraph .08 and section (d) are not workable with regard to 529 plans. ICI believed that some of the factors for determining suitability included in paragraph .08 would be ''largely irrelevant in the context of rendering advice to a 529 plan'' and the MSRB should modify the Revised Draft Rule to explicitly state that such factors would not apply to advice relating to 529 plans. In the absence of exempting 529 plans from needing to consider such factors, ICI asked the MSRB to clarify how it intends the listed factors to apply to 529 plans.

In consideration of these comments, the MSRB has modified proposed paragraph .08 (formerly paragraph .09) of the Supplementary Material to allow municipal advisors to base a suitability determination only on the listed factors that are applicable to the particular type of client being advised. The MSRB, accordingly, has inserted the phrase ''as applicable to the particular type of client'' as a qualifier to the list of factors in paragraph .08 that must be considered in a suitability analysis. The modifications proposed should address the commenters' concerns such as how factors such as ''financial capacity to withstand changes in market conditions'' would apply given that 529 plans are not dependent on external sources of revenue or funding to satisfy claims of investors. However, the listed factors in paragraph .08, consistent with the regulation of recommendations in other securities law contexts, are focused on the client and not the product involved.

Request for Clarification of Documentation and Procedural Requirements

In response to the Second Request for Comment, Piper Jaffray requested additional clarification on what a municipal advisor would need to do, and what documents would need to be created, to comply with the Revised Draft Rule's suitability requirements. Specifically, Piper Jaffray asked what the proposed rule change would require with regards to decisions that Piper Jaffray refers to as ''smaller decisions'' (*e.g.,* call features and whether to utilize a premium bond structure that has a lower yield to call).

The proposed rule change would require, pursuant to the duty of care, a municipal advisor to have a reasonable basis for any advice it provides to or on behalf of its client. Also, municipal advisors would be required to conduct a suitability analysis of recommendations of municipal securities transactions and municipal financial products that would comport with the requirements of proposed paragraph .08 of the Supplementary Material. Whether or not a suitability analysis would be required would depend, as previously discussed in Item II.A., on the facts and circumstances surrounding the communication made by the municipal advisor and whether the communication was a recommendation of a municipal securities transaction or municipal financial product. Advice as to the ''smaller decisions'' asked about by Piper Jaffray might, or might not, depending on the facts and circumstances of a particular instance, rise to the level of being a recommendation that would require a suitability analysis under the proposed rule change, even though such advice may relate to a municipal securities transaction or municipal financial product and therefore trigger other provisions of the proposed rule, because the advice might not reasonably be viewed as a ''call to action'' that would constitute a recommendation of a municipal securities transaction or municipal financial product. Note that even in the case of advice short of a recommendation, a subsequent communication that does constitute a recommendation requiring a suitability analysis might, depending on the particular facts and circumstances, require analysis at that time of a subject that was addressed in previous advice.

With regard to the recordkeeping requirements that would be required when providing a recommendation of a municipal securities transaction or municipal financial product, proposed MSRB Rule G–8(h)(iv) would require specifically that municipal advisors keep 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 determination as to suitability for a period of not less than five years. The MSRB believes that the proposed recordkeeping requirements will allow regulatory examiners to efficiently assess a municipal advisor's compliance with the suitability obligations of Proposed Rule G–42. The MSRB also believes that the proposed recordkeeping requirements will not overly burden municipal advisors because the MSRB understands that these documents are routinely made and retained by municipal advisors as a part of their normal business operations.

Suitability and Policy Related Considerations

In response to the First Request for Comment, BDA and Piper Jaffray stated that the factors to be considered by municipal advisors when determining whether a municipal securities transaction or municipal financial product is suitable for its municipal entity or obligated person client discussed in paragraph .08 (Suitability) of the Supplementary Material overlooks the effect that ''policy and political considerations'' could have on a suitability determination. Piper Jaffray requested that the MSRB clarify whether the determination of suitability should ''incorporate the policy directives and decisions of the issuer at the time the issue is undertaken.'' BDA requested that the MSRB clarify that, if a municipal advisor's client states its objective, the municipal advisor, in making its recommendation, does not need to assess the appropriateness of the client's stated objective but could ''generally accept the [objective].''

Section (a) and paragraph .01 of the Supplementary Material to Proposed Rule G–42 would require that municipal advisors exercise due care in performing their municipal advisory activities with respect to all of their clients. This duty would require, among other things, municipal advisors to provide their clients with informed advice. The MSRB believes that informed advice regarding the suitability of a municipal securities transaction or municipal financial product is the result of a municipal advisor making a reasonable inquiry into certain relevant information about the municipal advisor's client. For this reason, the MSRB has included in proposed paragraph .08 the requirement that a municipal advisor base its determination of suitability on any material information known by the municipal advisor after reasonable inquiry. Furthermore, proposed paragraph .09 of the Supplementary Material would obligate a municipal advisor to know and retain the essential facts concerning its client to allow the municipal advisor to effectively service the client. The MSRB believes that policy considerations could be materially relevant information under all of the particular facts and circumstances that municipal advisors may consider when determining the suitability of a municipal securities transaction or municipal financial product. A stated objective of the client as BDA posits could be made most clear by reducing it to writing and including it in the relationship documentation on the scope of the engagement.

Evidencing Evaluations and Delivery of Required Information Regarding Recommendations

Several commenters, including BDA, MSA, Northland and Lewis Young, commented on records and documentation requirements of the proposed rule change that would be applicable to municipal advisors.

In response to the First Request for Comment, BDA requested clarification regarding what books and records a municipal advisor would need to maintain to evidence evaluations or recommendations made by the municipal advisor. BDA commented that some evaluations or recommendations could be delivered orally to a client and that requiring a municipal advisor to memorialize each recommendation or evaluation in writing could prove impractical and/or costly. MSA asked, in response to the First Request for Comment, whether the information regarding recommendations and evaluations of which a municipal advisor is required to ''inform'' its client could be ''transmitted to the client orally or will each alternative require empirical evidence demonstrating the material risks, potential benefits, structure and characteristics?'' If oral transmission is acceptable, MSA then asked whether it would need to be documented by both parties. Also in response to the First Request for Comment, Northland expressed concerns regarding the Initial Draft Rule's requirement to discuss matters with the client, because it believed there is an implicit need to document these discussions therefore necessitating the use of written communications. However, Northland argued that written communications could result in a conflicting record that shows what the municipal advisor recommended as possibly in opposition to the course of action ultimately taken by its client. Northland was concerned that these potential conflicts could result in some exposure to liability in the event the justification of the decided upon course of action is challenged. Lewis Young contended that requiring municipal advisors, in section (d) of the Initial Draft Rule, to inform their clients of the risks and benefits of a particular structure or product when the client has already decided on a course of action (prior to engaging or seeking the advice of the municipal advisor) would yield little, if any, benefit. Lewis Young suggested only requiring the municipal advisor to inform its client of the matters discussed in section (d) when the client is considering, or presented with a recommendation of, a financial product, transaction or mechanism that is ''novel to the client.''

Proposed Rule G–8(h)(iv) would require a municipal advisor to maintain a copy of any document it created that was material to its review of a recommendation by another party or that memorializes the basis for any determination as to suitability. Section (d) of Proposed Rule G–42 would require a municipal advisor to inform its clients of 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; the basis upon which the municipal advisor reasonably believes that the recommended municipal securities transaction or municipal financial product is, or is not, suitable for the client; and 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. The MSRB notes that municipal advisors, under Proposed Rule G–42, would be required to ''inform'' their clients of such matters, rather than ''discuss,'' as previously required under the Initial Draft Rule. Under Proposed Rule G–42, a municipal advisor would be allowed to choose the appropriate method in which to communicate its evaluation of the material risks and benefits attendant to the recommendation. The method selected and used by the municipal advisor must, however, comport with the duty of care and duty of loyalty (as applicable) that is owed to its client and should, therefore, result in the municipal advisor's client receiving timely, full and fair notification of the matters provided for in proposed subsections (d)(i)–(iii) and that adhere to the guidance provided in proposed paragraph .08 of the Supplementary Material.

Exemption From Suitability Standard, ''Sophisticated'' Issuers

In response to the First Request for Comment, First Southwest expressed general support for a suitability standard for recommendations by municipal advisors but stated that certain clients of municipal advisors are capable of independently evaluating recommendations of municipal advisors and these clients should be exempt from the suitability standard in a manner similar to the ''sophisticated municipal market professional'' under MSRB Rule G–48. Lamont voiced a similar concern stating that many of its ''large sophisticated'' issuer clients do not want, or need, a review of the transaction they have already decided to undertake. Lamont commented that these types of clients are ''sufficiently capable of weighing the risks in a transaction and making their own decision about whether to proceed.''

In response to the Second Request for Comment, SMA stated that when a municipal securities transaction or municipal financial product has been decided upon by a municipal advisor's client and: (a) Is related to a project or event determined by the governing body of the municipal entity or its citizens to be in its interest and consistent with its goals; (b) is permitted by state statute as determined by municipal or bond counsel; and (c) involves a transaction or product which the municipality has employed in the past, then it seems suitability has been determined and the advisor ought to be able to rely on these facts and the closing documents as establishing a reasonable basis for suitability. Southern MA suggested that a municipal advisor should not be put in the position of substituting its judgment as to the suitability of a municipal securities transaction or municipal financial product for that of the municipal policy makers, citizens or state lawmakers.

The MSRB has determined that the requirements of section (d), and the related paragraphs of the supplementary material, should be applicable regardless of the municipal advisor's perception of the sophistication of its client or the client's perception of its own degree of sophistication. The proposed rule change is aimed at protecting municipal entities, obligated persons and the public interest and, as a result, the MSRB believes that exemptions such as those described by these commenters would frustrate that objective. However, in designing Proposed Rule G–42, the MSRB did incorporate many of the concepts that commenters believed were indicia of the sophistication of an issuer into the factors to be considered when determining the suitability of a recommendation. Under those factors, the considerations proffered by SMA could be relevant to, and therefore be part of, a municipal advisor's suitability analysis depending on all of the particular circumstances, though they might not alone be sufficient to support a suitability determination under the proposed rule change.

Specified Prohibitions

Several commenters provided input on Proposed Rule G–42(e)(i), which sets forth certain activities in which municipal advisors would be prohibited from engaging.

General Comments

In response to the First Request for Comment, NAIPFA and GFOA expressed general support for the specified prohibitions, NAIPFA stated that the section includes prohibitions that are ''important measures that are needed to eliminate certain practices that often carry unmanageable conflicts of interest inconsistent with Municipal Advisor fiduciary duties,'' and the prohibitions are appropriately tailored and would not impose undue regulatory burdens. Other commenters noted their general support for the prohibitions, but suggested some revisions or limitations, which are discussed in the section below.

Cooperman commented that the MSRB should determine, after a monitoring period since the passage of the Dodd-Frank Act, what, if any, abuses or inappropriate conduct remain that would require the regulation set forth in the proposed rule change. Alternatively, Cooperman suggested that the MSRB consider, at least initially, ''limiting the [proposed rule] to an enumeration of prohibited forms of conduct and practices'' rather than imposing extensive compliance, supervision and other requirements. In response to the Second Request for Comment, Lewis Young commented that the specified prohibitions subsections (e)(i) and (ii) (on the ban of certain principal transactions) are unnecessary because the matters addressed in those sections are adequately attended to in section (a) and should be intrinsic to a reputable municipal advisor's business practices. As such, Lewis Young recommended that these prohibitions be set forth in the supplementary material in order not to detract from the focus of the proposed rule. In response to such comments, the MSRB notes that, in many respects, Proposed Rule G–42 adopts a principles-based approach, enumerating prohibited forms of conduct and practice. However, regarding certain arrangements that the MSRB has identified as particularly prone to conflict with, or risk of breach of, the fiduciary duty and duty of care, the MSRB believes that the proposed rule change appropriately incorporates more specific requirements and prohibitions.

Excessive Compensation

In response to the First Request for Comment, SIFMA, Lewis Young and MSA commented that the provision that would prohibit receiving compensation that is excessive in relation to the municipal advisory activities actually performed (now Proposed Rule G–42(e)(i)(A)), did not include a sufficiently clear standard for how excessive compensation would be determined and failed to provide adequate amount of guidance to facilitate compliance. SIFMA expressed concern that without a clear standard or more guidance, such determinations would be made in hindsight, presumably by financial regulatory examiners, and to the detriment of municipal advisors. Lewis Young called the prohibition unworkable, expressed concern that it would require advisors to document all of their work and requested that the paragraph be deleted. SIFMA and Lewis Young also commented that municipal advisor compensation is subject to market forces, and therefore its reasonableness should be determined by a negotiation between the client and the municipal advisor. PRAG stated that the proposed rule change fails to contemplate instances where transaction fees are included in a municipal advisor's compensation to compensate the municipal advisor for services that it has provided but that were unrelated to the issuance of municipal securities. SIFMA and Lewis Young asked whether the practice of including fees for services a municipal advisor provided, if not related to the issuance of municipal securities, would be permitted under the proposed rule change. Columbia Capital commented that the MSRB should strike the phrase ''whether the fee is contingent upon the closing of the municipal securities transaction or municipal financial product,'' in paragraph .10 of the Supplementary Material of Proposed Rule G–42, and add, as an additional factor to be considered when determining whether compensation is excessive, a comparison of the municipal advisor's compensation to other professionals providing services on the transaction in question.

After carefully considering the comments submitted in response to the First Request for Comment, the MSRB incorporated guidance regarding excessive compensation in paragraph .10 of the Supplementary Material of the Revised Draft Rule and solicited further comment. Paragraph .10 of Proposed Rule G–42 sets forth various factors that municipal advisors should consider when determining the reasonableness of their compensation. These factors include: The municipal advisor's expertise, the complexity of the municipal securities transaction or the financial product, whether the fee is contingent upon the closing of the transaction or financial product, the length of time spent on the engagement and whether the advisor is paying any other costs related to the transaction or financial product. Furthermore, Proposed Rule G–42 would prohibit receiving compensation that is excessive in relation to the municipal advisory activities actually performed. Depending on the facts and circumstances of a particular municipal advisory relationship, either or both of these provisions could apply to a scenario like that posited by PRAG. The proposed rule change, however, would not prescribe the source of funds that could be used to pay the municipal advisor for its services. Finally, the phrase regarding contingent fees is not deleted from paragraph .10 of the Supplementary Material as the MSRB believes it is a relevant factor and appropriately included in a non-exhaustive list of other relevant factors.

Inaccurate Invoicing

In response to the First Request for Comment, Wulff Hansen commented that the prohibition on the delivery of inaccurate invoices (now Proposed Rule G–42(e)(i)(B)) should be modified to clarify that it would apply only to any overstatements of fees, expenses or activities, and not to any fee discounting by a municipal advisor. SIFMA commented that the prohibition should stand but should be modified to add materiality and knowledge qualifiers (*i.e.,* a municipal advisor may not intentionally deliver a materially inaccurate invoice).

The MSRB believes that the proposed rule change clearly implies that offering a payment discount from the services actually performed is a permissible activity because a municipal advisor would be able to accurately describe such a discount on its invoice. In response to the SIFMA comment, the MSRB notes that the scope of inaccuracy targeted by the proposed provision is limited to the significant subjects of the services performed and personnel who performed those services, and the MSRB believes any inaccuracy in an invoice on those subjects should be proscribed. In addition, the MSRB believes that the addition to the proposed provision of the state-of-mind elements that SIFMA suggested would not sufficiently protect municipal entity and obligated person clients.

Prohibition on Fee-Splitting

The Initial Draft Rule included a prohibition on making or participating in any fee-splitting arrangement with underwriters, and any undisclosed fee-splitting arrangement with providers of investments or services to a municipal entity or obligated person client (now Proposed Rule G–42(e)(i)(D)). In response to the First Request for Comment, GFOA supported the fee-splitting prohibition in the Initial Draft Rule, noting that it ''appears to be an inherent conflict, and should be avoided.'' NAIPFA supported the prohibition, but asked the MSRB to provide a definition of ''fee-splitting arrangements,'' under which independent contractors and subcontractors would fall outside of the prohibition. Lewis Young and Winters LLC stated that fee-splitting arrangements should be disclosed but not prohibited. SIFMA commented that fee-splitting arrangements with affiliates, if fully and fairly disclosed, should be permissible. SIFMA stated that there could be legitimate reasons for such arrangements, including fee structures requested by clients of an affiliate, and, with such disclosure, the parties should be free to engage in the fee arrangement believed to be most economical and efficient under the circumstances. NABL commented that the provision appears to apply to transactions even when the advice provided is exempted or excluded from that which would cause one to be a ''municipal advisor'' under the SEC Final Rule. Based on this assumption, NABL argued that the prohibition should apply only when a municipal advisor is giving ''non-exempt'' advice as part of the same transaction, not when it is giving advice that is exempt under the SEC Final Rule.

Several commenters provided examples of fee-splitting arrangements that they believed should not be prohibited. Cooperman stated that a municipal advisor should not be prohibited from outsourcing certain parts of its municipal advisory activities to independent contractors and subcontractors, including those that may have advisors on their staffs, when payment to those third parties is not dependent upon successful conclusion of the financing or payment to the municipal advisor of its fee. In addition, Cooperman stated the fee-splitting prohibition should not prevent two advisor firms from contracting with an issuer to perform services for a predetermined fee that is disclosed to the issuer. Lewis Young, who favored disclosure of fee-splitting in lieu of a complete prohibition, wrote that municipal advisors should be permitted to enter into a fee-splitting arrangement with a structuring agent that provides specific quantitative services on a transaction. Winters LLC asserted that a municipal entity or obligated person should be able to have its municipal advisor or other professionals (including underwriters, if after the underwriting period) receive compensation from investment providers or other service providers for providing oversight and performing other services so long as there is full and fair written disclosure of the fee-splitting or sharing arrangements. Lamont stated that allowing an investment provider to pay fees related to the solicitation of the investment by the municipal advisor, and that are within the permitted limits of the Internal Revenue Service rules, should be acceptable as long as the payments are disclosed to the issuer and each investment provider on the bid list. Wulff Hansen asked whether it would be permissible under the provision for a municipal advisor to arrange for a routine purchase of services on behalf of the advised client in a transaction with an entity in which the advisor has an interest (*e.g.,* a purchase of services from DTCC when the advisor is also a DTCC Participant and thus a part owner of DTCC). Finally, Piper Jaffray requested that the MSRB clarify that the fee-splitting prohibition, with regards to underwriters, applies to ''any issue for which it is serving as municipal advisor'' because the failure to link the prohibition to the actual advisory engagement could lead to unintended and adverse consequences.

The MSRB agrees with Piper Jaffray's comment and amended the provision in the Revised Draft Rule (now Proposed Rule G–42(e)(i)(D)) to prohibit a municipal advisor from making or participating in any fee-splitting arrangement with underwriters on any municipal securities transaction as to which it has provided or is providing advice.

The MSRB believes that the proposed rule change would help prevent violations of fiduciary duties and the duty of care by clearly identifying and prohibiting specific fee-splitting

arrangements that are particularly prone to conflict with such duties. Other fee-splitting arrangements would be permitted, provided they are fully and fairly disclosed.

Payments To Obtain/Retain an Engagement To Perform Municipal Advisory Activities

In response to the First Request for Comment, NABL commented that the Initial Draft Rule G–42 should not prohibit or require the disclosure of payments made to obtain or retain municipal advisory business, if those activities are engaged in by persons exempted from registration as a municipal advisor under SEC Rule 15Ba1–1.[68] Similarly, the NY State Bar commented that the prohibition on making payments for the purpose of obtaining or retaining an engagement to perform municipal advisory activities under subsection (g)(v) of the Initial Draft Rule (now proposed Rule G–42(e)(i)(E)) is unnecessarily restrictive with too narrow of an exemption. The NY State Bar stated that the provision should also permit payments to persons subject to comparable regulatory regimes (*e.g.,* banks, trust companies, broker-dealers and investment advisors) as well as to affiliates of the municipal advisor so long as, in either case, the payments are disclosed to the client. SIFMA commented that the proposed rule should allow for reasonable fees to be paid to affiliates because soliciting on behalf of affiliates does not trigger a requirement for a person to register as a municipal advisor under the SEC Final Rule. In response to the Second Request for Comment, Sanchez made a similar comment. In addition, SIFMA commented that the prohibition should not cover expenditures for normal business entertainment expenses as well as marketing and sales activities.

In light of the comments received, the MSRB modified the provision (now Proposed Rule G–42(e)(i)(E)(1)) so that it would not specifically prohibit municipal advisors from making payments to an affiliate

> for a direct or indirect communication with a municipal entity or obligated person on behalf of the municipal advisor where such communication is made for the purpose of obtaining or retaining an engagement to perform municipal advisory activities. . . .

The modification also would align the paragraph with Section 15B(e)(9) of the Exchange Act,[69] which allows affiliates of the municipal advisor to solicit on behalf of the municipal advisor without triggering the municipal advisor registration requirement for the affiliate. The MSRB would clarify, in proposed subparagraph (e)(i)(E)(2), that a municipal advisor may pay reasonable fees to another municipal advisor registered as such with the Commission and the Board for making a similar communication on behalf of the municipal advisor making such payments. The MSRB would also clarify, in proposed subparagraph (e)(i)(E)(3), that payments that would qualify as permissible normal business dealings under current MSRB Rule G–20 also would not violate the prohibition. The revisions would harmonize the proposed rule change with relevant federal securities laws and rules.

Additional Comments on Specified Prohibitions

BDA and Piper Jaffray suggested adding two prohibitions to Proposed Rule G–42. In response to the First and Second Requests for Comment, Piper Jaffray suggested adding a specified prohibition that would prohibit a municipal advisor from taking into account whether it competes with other firms when the advisor makes a recommendation to its client (*e.g.,* a recommendation to the client regarding which broker-dealer the client should hire as underwriter). In response to the First Request for Comment, BDA and Piper Jaffray suggested a second prohibition, which would prohibit a municipal advisor that is not also registered as, or affiliated with, a dealer, from using the term ''independent,'' if used in a manner intended to convey to potential clients that the municipal advisor is free from any potential conflicts of interest, and imply that, in contrast to advisors also registered as dealers, the municipal advisor would provide better advice. Piper Jaffray also stated that continued use of the term ''independent'' to connote an advisor free from conflicts should be specifically prohibited in light of the issues its continued use could create if market participants confused such advisors with a person acting as an ''independent registered municipal advisor'' as used in the SEC Final Rule.[70]

The MSRB has not incorporated the prohibitions suggested by BDA and Piper Jaffray. To the extent the described conduct constitutes a material misrepresentation, the MSRB believes it is already appropriately addressed by Proposed Rule G–42 and existing MSRB Rule G–17, under which municipal advisors, in the conduct of their municipal advisory activities, must not engage in any deceptive, dishonest or unfair practice with any person.

Prohibition on Principal Transactions

The MSRB received extensive comments on the proposed provision to prohibit a municipal advisor (and its affiliates) from engaging in certain principal transactions (as defined in the proposed rule) with a municipal entity client of the municipal advisor (''prohibition on principal transactions'' or ''ban''). Specifically, Proposed Rule G–42(e)(ii) generally would prohibit a municipal advisor to a municipal entity client, and any affiliate of such municipal advisor, from engaging in a principal transaction directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing, or has provided, advice.[71] Three related provisions of the proposed rule, subsection (f)(i) and paragraphs .07 and .11 of the Supplementary Material, would, respectively, define the phrase, ''engaging in a principal transaction,'' clarify the relationship between the proposed ban and Rule G–23, and provide guidance regarding the term ''other similar financial products'' in connection with principal transactions as defined in subsection (f)(i). Comments regarding the ban and the related provisions are discussed below.

General

In response to the First Request for Comment, many commenters raised concerns regarding: (1) The application of the ban to obligated person clients of municipal advisors; (2) the scope of the ban; (3) the meaning of ''principal transaction'' and ''principal capacity;'' (4) the ban's application to transactions by affiliates of municipal advisors; (5) the absence of an exception to the ban for an advisor or its affiliate based upon full and fair disclosure and the written consent of a client; and (6) the relationship between the ban and Rule G–23. In response to the Second Request for Comment, most of the comments focused on: (1) The scope of principal transactions that would be considered ''directly related'' to the advised transaction and come within the ban; (2) the ban's application to transactions by affiliates of municipal advisors; and (3) the relationship between the ban and Rule G–23.

[68] 17 CFR 240.15Ba1–1.

[69] 15 U.S.C. 78*o*–4(e)(9).

[70] *See, e.g.,* SEC Final Rule, 78 FR at 67471.

[71] In the Initial Draft Rule, the ban is set forth in section (f); in the Revised Draft Rule and the proposed rule change, the ban is set forth in subsection (e)(ii).

Ban Does Not Apply to Obligated Person Clients

In the Initial Draft Rule, the ban prohibited a municipal advisor and its affiliates from engaging in principal transactions with municipal entity and obligated person clients. The ban in Proposed Rule G–42(e)(ii) no longer would apply to principal transactions with obligated person clients. As a result, the comments urging that the ban not apply to obligated persons are not incorporated in this discussion, except to note that such comments were considered and the MSRB modified the proposed ban such that it would not apply to principal transactions with such persons.

Scope and ''Directly Related To''

In Initial Draft Rule G–42, the prohibition on principal transactions was significantly broader than the ban as modified in the Revised Draft Rule and as further narrowed in this proposed rule change. In the Initial Draft Rule, a municipal advisor (and its affiliates) generally were prohibited from engaging in any transaction in a principal capacity to which an obligated person client or a municipal entity client of the municipal advisor would be the counterparty. In response to the First Request for Comment, many commenters[72] interpreted the proposed prohibition quite broadly and expressed concerns regarding the scope of the proposed prohibition on principal transactions by municipal advisors (and their affiliates) with the clients of such municipal advisors.[73] Commenters, including ABA, BDA, NABL and Piper Jaffray, interpreted the ban as covering activities and transactions that were unrelated to the municipal advisory relationship. The ABA commented that ''because banks almost always provide banking products and services in a principal capacity, the prohibition would prevent commercial banks and their affiliates from providing any other banking products, such as deposit accounts, loans, or cash management services . . . despite the fact that these products and services are exempt from the municipal advisor regulatory regime.'' BDA, Frost, SIFMA and Zion, among others, raised similar concerns regarding the broad reach of the prohibition.

After carefully considering the comments, the prohibition on principal transactions was significantly narrowed and clarified, as set forth in Revised Draft Rule G–42(e)(ii). The MSRB limited the ban to ''a principal transaction *directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing advice''* (emphasis added). The Revised Draft Rule would thus prohibit a municipal advisor (and its affiliates) to a municipal entity client from engaging in a principal transaction directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing advice. The modification was designed to exclude many of the transactions that some commenters read as potentially covered by the Initial Draft Rule, including the taking of a cash deposit or the payment by a client solely for professional services.

In response to the Second Request for Comment, some commenters supported the changes to the proposed rule text. Several other commenters continued to raise concerns regarding what they believed to be the overly broad scope of the ban. Conversely, one commenter stated that the ban in Revised Draft Rule G–42(e)(ii) had become too narrow. GFOA approved of the modification narrowing the proposed ban to ''a principal transaction directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing advice,'' and Wells Fargo noted that the modification mitigated the impact of the proposed ban. ABA also welcomed the revision, but suggested additional changes. In addition, BDA, NY State Bar, Piper Jaffray and SIFMA suggested that the ban be modified further to narrow or clarify the scope of the ban. ABA recommended that the provision require the advice provided by the municipal advisor be provided pursuant to a municipal advisory relationship; NY State Bar recommended that the prohibition not apply where the municipal advisor does not make a recommendation to the municipal advisory client to enter into a transaction with the advisor or its affiliate; and SIFMA recommended that the provision ban only those principal transactions that are directly related to the advice the municipal advisor is providing, not merely the same municipal securities transaction or municipal financial product in connection with which the advice is provided.[74] BDA and Piper Jaffray commented that the term ''directly related'' was unclear, and recommended alternative language. In Piper Jaffray's view, the ban should be limited to a transaction or issuance where a firm served as a municipal advisor and about which advice was rendered. Alternatively, Piper Jaffray suggested that the ban should cover transactions ''directly related to the advice given rather than directly related to the transaction itself.'' Applying the proposed ''directly related to'' standard to certain hypothetically paired transactions, BDA asked whether one of each pair of such transactions would be considered directly related to the second transaction and therefore subject to the proposed prohibition, and also proposed a modification to the ban.[75] Conversely, Lewis Young argued that, with the changes set forth in the Revised Draft Rule, the scope of the prohibition on principal transactions has gone from ''too broad to too narrow'' because the definition of ''engaging in a principal transaction'' (discussed in greater detail

[72] Commenters that expressed such concerns include ABA, BDA, Cape Cod Savings, Coastal, Frost, GFOA, GKB, JP Morgan, Kutak, NABL, NY State Bar, Parsons, Piper Jaffray, SIFMA and Zion.

[73] SIFMA suggested narrowing the proposed provision to:

A municipal advisor to a municipal entity client, and any affiliate of such municipal advisor, is prohibited from engaging in a principal transaction directly related to the *advice rendered by such municipal advisor* (emphasis added).

BDA suggested the following alternative:

A municipal advisor, and any affiliate of such municipal advisor, is prohibited from engaging in a principal transaction with a municipal entity client if the structure, timing or terms of such principal transaction was [sic] established on the advice of the municipal advisor in connection with a municipal advisory relationship with such municipal entity client.

[74] In response to the Second Request for Comment, ABA recommended the provision be modified to read:

A municipal advisor to a municipal entity client, and any affiliate of such municipal advisor, is prohibited from engaging in a principal transaction directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing advice *pursuant to a municipal advisory relationship.*

SIFMA recommended the provision be modified to read:

A municipal advisor to a municipal entity client, and any affiliate of such municipal advisor, is prohibited from knowingly engaging in a [prohibited] principal transaction.

[75] In connection with interpreting the scope of the ''directly related to'' standard, BDA asked whether: (1) Selling securities as a principal after winning a competitive bid for an open market refunding escrow on a refunding bond issue for which the firm was a municipal advisor would be a transaction ''directly related to'' the refunded bond issue and therefore a prohibited principal transaction; (2) acting as the underwriter on a series of variable rate bonds would be directly related to acting as the municipal advisor for a related swap, and be prohibited; and, (3) underwriting a refunding issue years after serving as a municipal advisor for the initial issue would be a transaction that would be considered directly related to the initial issue and prohibited.

BDA recommended the provision be modified to delete the ''directly related to'' standard and substitute: ''if the structure, timing or terms of such principal transaction was established on the advice of the municipal advisor in connection with a municipal advisory relationship with such municipal entity client.''

below) does not extend fully to the variety of principal transactions in which a municipal advisor could engage, which would be in conflict with its municipal advisory role and fiduciary duty (*e.g.,* a bank loan as a substitute for an issuance of municipal securities).

The principal transactions ban is incorporated in the proposed rule change as Proposed Rule G–42(e)(ii). The MSRB has determined not to narrow, broaden or otherwise modify the standard—''directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing advice''—in response to the comments received. The MSRB believes that the various alternative rule texts proposed by commenters would not be more effective or efficient means for achieving the stated objective of Proposed Rule G–42(e)(ii), which is to eliminate a category of particularly acute conflicts of interest that would arise in the fiduciary relationship between a municipal advisor and its municipal entity client. The alternatives offered by various commenters are similar in that they would seek to limit the scope of prohibited transactions to those pertaining to the advice rendered by the municipal advisor. If adopted, such a change could leave transactions that have a high risk of self-dealing insufficiently addressed. For example, a municipal advisor that provided advice to a municipal entity regarding the timing and structure of a new issuance arguably would not be prohibited from acting as principal in entering into an interest rate swap for the same issuance so long as the advisor refrained from advising on the swap. In addition, in response to the comments that the standard would continue to raise questions whether a transaction was prohibited under Proposed Rule G–42(e)(ii) and the suggestion that the MSRB further amend the provision to clarify the provision, the MSRB does not believe it would be feasible or desirable, given the principled nature of the provision, to specify in advance its application in all circumstances. As noted above, the proposed principal transactions ban is revised to clarify that the prohibition applies both to principal transactions that occur while the municipal advisor is providing advice with respect to a directly related municipal securities transaction or municipal financial product, and after the municipal advisor has provided such advice.

''Engaging in a Principal Transaction'' and ''Other Similar Financial Products''

In response to the First Request for Comment, certain commenters, including GFOA, NAIPFA, SIFMA and Wulff Hansen, commented that the MSRB should provide additional guidance regarding the meaning of various terms (*e.g.,* ''principal capacity'' and ''principal transaction'') for purposes of interpreting the proposed prohibition on principal transactions. Several commenters, including GFOA, Wulff Hansen and First Southwest, sought clarification regarding the types of transactions that would constitute principal transactions. For example, the GFOA requested that the MSRB provide examples of prohibited and acceptable practices; Wulff Hansen asked that the MSRB specify whether the sale of other additional municipal advisory or related services would constitute a prohibited principal transaction; and First Southwest asked whether a municipal advisor that also facilitates private placements would be engaged in a principal transaction.

In response to comments, the Revised Draft Rule G–42(f)(i) added, for purposes of the Revised Draft Rule, a defined term, ''engaging in a principal transaction'' to mean: ''when acting as principal for one's own account, selling to or purchasing from the municipal entity client any security or entering into any derivative, guaranteed investment contract, or other similar financial product with the municipal entity client.''

In response to the Second Request for Comment, ABA and GFOA expressed support for the proposed defined term. Another commenter, Sanchez, asked the MSRB to include a non-exhaustive list of specific common roles (such as underwriter) in addition to the general description. NY State Bar recommended two significant changes intended to narrow the scope of the prohibition and the definition of principal transaction: (1) The ''somewhat open-ended'' phrase ''other similar financial product'' should be amended to refer exclusively to municipal financial products, as defined in the Exchange Act; and (2) the definition of ''engaging in a principal transaction'' should be amended to make clear that the term does not include any of the banking activities as to which a bank may provide advice without being registered as a municipal advisor pursuant to the exemption in the SEC Rule 15Ba1–1(d)(3)(iii),[76] including holding investments in a deposit or savings account, certificate of deposit or other deposit instrument issued by a bank; extensions of credit by a bank to a municipal entity or obligated person, including the issuance of a letter of credit; the making of a direct loan, or the purchase of a municipal security by the bank for its own account; holding funds in a sweep account; or investments made by a bank acting in the capacity of an indenture trustee or similar capacity.

In response to comments filed regarding the Second Request for Comment, including Lewis Young's, the proposed rule would provide additional guidance regarding the term, ''other similar financial products.'' Proposed Supplemental Material paragraph .11 would provide that, as used in Proposed Rule G–42(f)(i), ''other similar financial products,'' ''includes a bank loan, but only if it is in an aggregate principal amount of $1,000,000 or more and it is economically equivalent to the purchase of one or more municipal securities.'' The MSRB notes that the term ''other similar financial products'' is not limited to refer exclusively to municipal financial products, as defined in the Exchange Act, in that a fiduciary's obligation to its client—not to engage in principal transactions in which the fiduciary's financial interests and concerns conflict with those of the client—is not so limited. For the same reason, the MSRB has determined not to limit the scope of banned transactions, which are covered based generally on conflicts principles, to the category of transactions as to which advising triggers a registration requirement as a municipal advisor.

Exceptions to Ban

In the First Request for Comment, the MSRB specifically sought comments on whether a ban on principal transactions by municipal advisors was the appropriate regulatory approach, or whether a municipal advisor should be permitted to engage in certain types of principal transactions with its client, with full and fair disclosure and written client consent, and, if so, what types of principal transactions should be allowed.

In response to the First Request for Comment, several commenters, including ABA, First Southwest, Frost, GKB, Kutak, JP Morgan, NABL and SIFMA, expressed concerns regarding what they viewed as the overly broad prohibition on principal transactions between municipal advisors and their clients. Several commenters, including the ABA, Cape Cod Savings, Frost, NABL, SIFMA and Zion, stated that the prohibition could do a disservice to municipal entities by unnecessarily and

[76] 17 CFR 240.15Ba1–1(d)(3)(iii).

substantially restricting the choices available to municipal entities that engage their municipal advisors (or their affiliates) in other types of transactions that would be prohibited by the Initial Draft Rule. In addition, several commenters, including ABA, Kutak, NABL, Parsons, SIFMA, Sutherland and Wells Fargo, believed that a municipal advisor should be permitted to engage in certain types of principal transactions with its clients if the municipal advisor provides its client with full and fair disclosure and then receives informed consent from the client. NABL stated that the proposed ban would conflict with common law, under which an agent's fiduciary duties of loyalty and care could be waived or otherwise modified by the principal if the principal is not legally incompetent. Kutak commented that the Initial Draft Rule should not prohibit all principal transactions with municipal entities when the client is sufficiently sophisticated to adequately assess the risks of the transactions. Kutak believed transactions involving an investment in an instrument where an established market exists and a municipal entity client could readily ascertain the reasonableness and fairness of the price should be allowed under the Initial Draft Rule.

Also, multiple commenters, including ABA, Kutak, NABL and SIFMA (in response to the First Request for Comment) and FSR and Zion (in response to the Second Request for Comment), noted that under Section 206(3) of the Investment Advisers Act and other regulatory regimes, certain principal transactions are permitted based upon full and fair disclosure and client consent.[77] The commenters suggested that a similar mechanism should be included in the ban that would allow municipal advisors to engage in principal transactions with their municipal entity clients, subject to similar disclosure and consent requirements. NABL also commented that, if the MSRB adopted a provision that was consistent with the SEC's guidance under the Investment Advisers Act regarding an exception to a ban based on disclosure and informed consent, the MSRB should provide clear guidance to market participants to avoid confusion.

In contrast, commenters Lewis Young and NAIPFA supported the proposed ban on principal transactions and did not recommend creating exceptions or narrowing its scope. Lewis Young commented that the ban was appropriate, stating that a party cannot be both a fiduciary and a principal party in a buyer/seller relationship if the sale is an asset, financial product or something other than services that are compatible with the fiduciary role.

The MSRB carefully considered the comments received that urged the MSRB to include one or more exceptions to the prohibition on principal transactions. After considering the fiduciary duty of the municipal advisor in its relationship to a municipal entity client and the possibilities for self-dealing, the MSRB believes that the proposed prohibition on principal transactions is sufficiently targeted and should be retained. In addition, the MSRB believes that exceptions to the prohibition based on disclosure and client consent, even if limited to sophisticated municipal entities, would not sufficiently protect municipal entity clients from potential self-dealing-related abuses. The prohibition has been narrowed to ban only those transactions that (1) are ''directly related'' to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing or has provided advice and (2) are purchases or sales of a security or involve entering into a derivative, guaranteed investment contract, or other similar financial product with the municipal entity client (as discussed, *supra*). In the MSRB's view, the prohibition on principal transactions should not at this juncture be modified or narrowed, given the acute conflicts of interest presented and the risk of self-dealing by a regulated entity (or its affiliate).[78]

Affiliates

In response to the First Request for Comment, a number of commenters commented on the ban's coverage of principal transactions by affiliates of a municipal advisor, including ABA, Frost, JP Morgan, Parsons, Piper Jaffray, SIFMA, Wells Fargo and Zion.

The ABA, SIFMA and other commenters commented generally that other fiduciary regimes do not prohibit all affiliates of a fiduciary from engaging in principal transactions with the party owed the fiduciary duty. Wells Fargo also sought to limit the coverage of the ban, commenting that the ban should not apply to certain affiliates. In Wells Fargo's view, affiliates of large financial institutions often offer substantially different services, operate with distinct governance structures and employ information barriers, and, in such instances, if a non-municipal advisor affiliate is not connected to the municipal advisor relationship, the risk of a conflict of interest in a principal transaction between a municipal advisor client and the non-municipal advisor affiliate is significantly diminished. Wells Fargo suggested that the MSRB not apply the ban to affiliates or, at a minimum, limit the ban to principal transactions of affiliates that are directly related to the municipal advisory relationship that the municipal advisor affiliate has with the client. ABA, NABL, SIFMA, Wells Fargo, Zion and other commenters generally expressed concerns related to regulating conduct of affiliates of municipal advisors, specifically the imposition of compliance burdens on the affiliates and possible unintended consequences to clients if certain products and services offered by affiliates of the municipal advisor were no longer available to clients. ABA and NABL commented that the MSRB does not have apparent authority to regulate the conduct of affiliates of municipal advisors that are not brokers, dealers or municipal securities dealers, and thus, any ban should be narrowly-tailored and addressed to the municipal advisor's right to advise, rather than its affiliates' rights to engage in unrelated transactions.

In response to the Second Request for Comment, ABA, FSR, SIFMA and Wells

[77] *See* 15 U.S.C. 80b–6 and the rules adopted thereunder, which prohibit an adviser, acting as a principal for its own account, from knowingly selling any security to or purchasing any security from a client for its own account, without disclosing to the client in writing the capacity in which it (or an affiliate) is acting and obtaining the client's consent before the completion of the transaction.

SIFMA also referred to the regulation of swap dealers and security-based swap dealers that also serve as advisors to Special Entities (which includes municipal entities) under the CEA. *See* 7 U.S.C. 1 *et seq.* According to SIFMA, the CEA does not preclude such advisors from entering, in a principal capacity, into derivatives transactions with the Special Entities that they advise, including municipal entities, subject to the duty of the advisor to act in the best interests of the Special Entity.

[78] Similar concerns regarding conflicts of interests arising when a regulated entity would provide financial advice to a municipal issuer and also serve as underwriter were raised by the MSRB and commenters in connection with SR–MSRB–2011–03, a proposed rule change to amend MSRB Rule G–23 relating to the activities of financial advisors, which was approved by the Commission. *See* Exchange Act Release No. 64564 (May 27, 2011), 76 FR 32248, 32249 (June 3, 2011) (order approving File No. SR–MSRB–2011–03) (''[T]he proposed rule change resulted from a concern that a dealer financial advisor's ability to underwrite the same issue of municipal securities, on which it acted as financial advisor, presented *a conflict that is too significant for the existing disclosure and consent provisions of Rule G–23 to cure.* Even in the case of a competitive underwriting, the perception on the part of issuers and investors that such a conflict might exist was sufficient to cause concern that permitting such role switching was not consistent with 'a free and open market in municipal securities' '' (emphasis added)).

Fargo included significant comments that focused on the ban's application to transactions by affiliates. With respect to affiliates, among the concerns raised was the difficulty that municipal advisors and their affiliates might have in identifying transactions that are related to an advised transaction, particularly within large organizations, and the likely significant cost of compliance.

Commenters, such as SIFMA and Wells Fargo, also questioned the value of extending the prohibition to affiliates of a municipal advisor, stating that, in scenarios where the affiliate has no knowledge of the municipal advisory relationship, or where the municipal advisor has no knowledge of an affiliate's contemplated principal transaction, the parties would not be likely to engage in self-dealing or profit from the affiliation.

SIFMA suggested that the MSRB include the emphasized modifier in subsection (e)(ii) as follows: ''A municipal advisor to a municipal entity client, and any affiliate of such municipal advisor, is prohibited from *knowingly* engaging in a principal transaction. . . .'' (emphasis added), which is the same modifier contained in the provision on principal transactions in the Investment Advisers Act.[79] Wells Fargo suggested a modification to exempt municipal advisor affiliates operating with information barriers, stating that such entities are unlikely to engage in the self-dealing that the rule is aimed at preventing.

After considering the fiduciary duty of the municipal advisor in its relationship to a municipal entity client and the risk of self-dealing, the MSRB believes that the proposed prohibition on principal transactions, including its application to affiliates, is sufficiently targeted. In the MSRB's view, the proposed prohibition should be retained without exceptions, including one based on disclosure and consent, for the reasons set forth above, given the acute nature of the conflicts of interest presented and the risks of self-dealing by affiliates in transactions that are ''directly related'' to the same municipal securities transaction or municipal financial product as to which the affiliated municipal advisor is providing or has provided advice. Significantly, the prohibition is limited to certain types of transactions (*i.e.,* purchases or sales of a security or those involving entering into a derivative, guaranteed investment contract, or other similar financial product). Finally, in connection with affiliates, if the prohibition on principal transactions were modified by ''knowingly,'' the MSRB believes the standard would be overly stringent, which could hinder regulatory examinations and enforcement.

Relationship Between the Ban and Rule G–23

In the First Request for Comment, the ban prohibiting municipal advisors (and their affiliates) from engaging in principal transactions with the municipal advisor's clients included the exception: ''Except for an activity that is expressly permitted under [MSRB] Rule G–23'' (''Rule G–23 exception''). The Rule G–23 exception was included to address the interrelationship between the proposed specific prohibition on principal transactions in Initial Draft Rule G–42 and principal transactions that are permitted by underwriters under Rule G–23.

Commenters sought clarity regarding the relationship between Rule G–23 and the prohibition on principal transactions in the Initial Draft Rule. In response to the First Request for Comment, commenters asked whether the prohibition on principal transactions was in conflict with principal transactions discussed in Rule G–23, under which a municipal advisor could acquire, as a principal, all or any portion of an issuance of municipal securities for which the municipal advisor had provided advice, as long as the municipal advisor complied with Rule G–23. BDA and GKB noted that, although the provision in the proposed ban referenced an exception for activities that are expressly permitted under Rule G–23, it was unclear what principal transactions would be permitted. Lamont commented that MSRB rules applicable to municipal advisors should not conflict with MSRB rules applicable to dealers regarding principal transactions, observing that, in its view, a fiduciary duty to the issuer will require additional steps to ensure that the pricing has been at least as favorable as having a third party in the transaction.

After careful consideration of the comments, the MSRB developed the Revised Draft Rule to clarify the relationship between the proposed ban on principal transactions and those principal transactions currently permitted under Rule G–23. Specifically, paragraph .07 to the Supplementary Material of the Revised Draft Rule described the Rule G–23 exception to the ban, providing that subsection (e)(ii) would not apply to an acquisition as principal, either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from an issuer all or any portion of an issuance of municipal securities, provided that the municipal advisor complied with the requirements of Rule G–23. Thus, the Rule G–23 exception was more clearly described using the particular terminology in Rule G–23, rather than solely cross-referencing Rule G–23.

Several of the comments received in response to the Second Request for Comment continued to seek clarification regarding the Rule G–23 exception, desiring to avoid confusion regarding any express and direct conflict between the ban and Rule G–23. GFOA sought additional amendments to paragraph .07 of the Supplementary Material, seeking to ''ensure that no component of a final Rule on G–42 removes the authority of issuers to decide for themselves how they utilize a [municipal advisor] or underwriter on a transaction so long as compliance with MSRB Rule G–23, MSRB Rule G–42 and the SEC's Municipal Advisor Rule are maintained.'' In BDA's view, the Revised Draft Rule language did not clarify the provision compared with the prior language regarding when a municipal advisor could act as a principal on the same transaction for which it is providing advice.

Sanchez appeared to interpret the provision to mean that a transaction permitted by Rule G–23 would be deemed in all cases to be lawful vis-a-vis other requirements under proposed Rule G–42 (such as the duty of loyalty) and under other laws (such as the statutory fiduciary duty). Columbia Capital commented that the sentence regarding the Rule G–23 exception in paragraph .07 of the Supplementary Material should be deleted because it ''contemplates a situation where an MA could serve as a principal in a transaction for which it provides MA services, creating a conflict'' with the proposed prohibition on principal transactions. Finally, ABA commented that the clarification regarding the conflict between Rule G–23 and draft Rule G–42(e)(ii) is unnecessary, or, if the clarification is retained, the phrase, ''provided that the municipal advisor complies with all of the provisions of Rule G–23,'' should be deleted and the phrase, ''provided that such a transaction is not prohibited by the provisions of Rule G–23,'' should be incorporated.

The MSRB notes that the purpose of the sentence regarding the Rule G–23 exception in paragraph .07 of the Supplementary Material is to avoid a potential inconsistency in the MSRB's

[79] *See* 15 U.S.C. 80b–6(3).

rules by providing specifically in Proposed Rule G–42, until such time as the MSRB may further review and potentially revise Rule G–23, that the specific ban on principal transactions in proposed subsection (e)(ii) does not prohibit a type of principal transaction that is already addressed and prohibited to a certain extent by Rule G–23. To further clarify this point, and respond to the comment by ABA, the MSRB has deleted the phrase ''provided that the municipal advisor complies with all the provisions of Rule G–23'' from the end of paragraph .07, and substituted the phrase ''that is a type of transaction that is addressed by Rule G–23.'' Also, in response to the comments requesting additional clarification, the MSRB has included the phrase ''on the basis that the municipal advisor provided advice as to the issuance.'' Proposed paragraph .07 of the Supplementary Material, as revised, would provide:

> In addition, the specific prohibition in subsection (e)(ii) . . . shall not apply to an acquisition as principal, either alone or as a participant in a syndicate or other similar account formed for the purpose of purchasing, directly or indirectly, from an issuer all or any portion of an issuance of municipal securities *on the basis that the municipal advisor provided advice as to the issuance because that is a type of transaction that is addressed and prohibited in certain circumstances by Rule G–23* (emphasis added).

The MSRB cautions that this provision is quite limited, providing an exception only to the specific prohibition in subsection G–42(e)(ii); and it would not mean, for example, that a transaction not prohibited by Rule G–23 is deemed in all cases to be lawful vis-a-vis all other requirements under Proposed Rule G–42 (such as the duty of loyalty) and under other laws (such as the statutory fiduciary duty).

Inadvertent Advice—Supplementary Material .06

In response to the Second Request for Comment, several commenters expressed concerns and suggested changes to the inadvertent advice exclusion in paragraph .06 of the Supplementary Material to the Revised Draft Rule. First, NAIPFA believed the paragraph impermissibly creates an additional exemption from the Commission's definition of the term ''municipal advisor'' and is inconsistent with Rule G–23, allowing broker-dealers to provide advice to municipal entities and obligated persons as municipal advisors without becoming subject to corresponding fiduciary responsibilities and ultimately allowing such municipal advisors to serve as underwriters of the securities being issued. Similarly, WM Financial believed paragraph .06 negated Rule G–23 and effectively allowed broker-dealers to serve as municipal advisors and then switch to serving as underwriters, undermining the definition of ''municipal advisor'' and the exemptions thereto provided by the SEC. Contrary to NAIPFA and WM Financial, Sanchez stated that ''it appears reasonably clear at the moment that Supplementary Material .06 is only intended to provide relief from subsections (b) and (c) of Proposed Rule G–42;'' however, he believed it would be useful for the MSRB to also include an affirmative statement that even inadvertent advice is subject to all other rules and requirements applicable to municipal advisory activities and financial advisory relationships entered into by broker-dealers under Rule G–23, Commission rules, and the fiduciary duty set forth in the Exchange Act.

NAIPFA and WM Financial misinterpreted the safe harbor provided by paragraph .06 as broadly relieving a municipal advisor of other regulatory requirements. To address such confusion, the MSRB has revised paragraph .06 of the Supplementary Material to include a clarifying statement that the relief the paragraph provides ''has no effect on the applicability of any provisions'' of Proposed Rule G–42, other than sections (b) and (c) (relating to documentation of the municipal advisory relationship and the disclosure of conflicts of interest, respectively) or any other legal requirements applicable to municipal advisory activities, which would include, but are not limited to, SEC rules and Rule G–23.

Second, SIFMA suggested that the MSRB broaden the limited safe harbor provided by paragraph .06 to relieve municipal advisors that inadvertently engage in municipal advisory activities from compliance with section (d) and subsection (e)(ii) of the Revised Draft Rule. Section (d) would require a suitability analysis of recommendations made by the municipal advisor or by a third party while subsection (e)(ii) would prohibit principal transactions directly related to the same municipal securities transaction or municipal financial product as to which the municipal advisor is providing or has provided advice. The MSRB believes that, despite inadvertently engaging in municipal securities activities, a municipal advisor should not be relieved of complying with the suitability analysis requirement to the extent the municipal advisor made or reviewed a recommendation as contemplated by Proposed Rule G–42(d). Further, the MSRB does not believe, as SIFMA suggested, that firms would be less likely to perform the disclaimer process under paragraph .06 because doing so would not permit them to engage in a principal transaction prohibited under Proposed Rule G–42(e)(ii). Specifically, use of the exemption under paragraph .06 would only relieve a municipal advisor of compliance with the requirements of Proposed Rule G–42(b) and (c), and the prohibition on principal transactions would apply to the municipal advisor regardless. Therefore, the MSRB has not revised paragraph .06 in response to these comments.

Third, NAIPFA highlighted the importance of prompt use of the safe harbor provided by paragraph .06, suggesting that the proposed rule require utilization within ten days of discovery of the inadvertent advice. The MSRB has not prescribed a strict time frame for when the documentation must be provided by the municipal advisor beyond the general ''promptly'' standard, as doing so would create an arbitrary bright line that would be of limited benefit to municipal advisors or their clients. In response to the comment and to ensure that municipal advisors seeking to obtain the relief provided under paragraph .06 do so in a timely manner after having discovered that they inadvertently provided advice, the MSRB modified paragraph .06 to require municipal advisors to provide the documentation it prescribes ''as promptly as possible *after discovery''* (emphasis added).

Fourth, SIFMA noted that there are circumstances in which a registered municipal advisor could be engaged in municipal advisory activities for some clients, but inadvertently provide advice to another client, and, therefore, could not state that it ''has ceased engaging in municipal advisory activities'' to comply with paragraph .06. In response to the comment, the MSRB has revised the disclaimer required by subparagraph (a) of paragraph .06 of the Supplementary Material to state that, effective immediately, the municipal advisor has ceased engaging in municipal advisory activities ''*with respect to that municipal entity or obligated person in regard to all transactions and municipal financial products as to which advice was inadvertently provided* . . . .'' (emphasis added). This revision would clarify that the municipal advisor is not required to cease *all* municipal advisory activities to obtain the relief provided by paragraph .06.

Fifth, NAIPFA highlighted the importance of the identification of the

inadvertent advice, suggesting requiring the identification of absolutely *all* of the inadvertent advice. In response to this comment, the MSRB revised subparagraph (c) of paragraph .06 to require that the municipal advisor identify all of the advice that was provided inadvertently, based on a reasonable investigation. This objective standard for the investigation would avoid requiring municipal advisors to go to impractical lengths to ensure that all inadvertent advice was identified, and the MSRB believes this would be sufficient to allow municipal advisor clients to assess risk exposure from any reliance on the advice and determine what potential mitigating actions need to be taken.

Finally, SIFMA suggested that the MSRB should carve out an exception for all advice that is incidental to brokerage/securities execution services. In the MSRB's view, SIFMA's request, as noted above, is a request that the MSRB interpret the SEC Final Rule and the definition of ''municipal advisor,'' therein. The authority to interpret the Commission's rule lies with the Commission and the request should be directed to the Commission. As such, the MSRB declines to revise paragraph .06 of the Supplementary Material in this manner.

Trigger for Municipal Advisor Relationship

Subsection (f)(vi) would define ''municipal advisory relationship'' for purposes of Proposed Rule G–42 and states that a municipal advisory relationship will ''be deemed to exist when a municipal advisor enters into an agreement to engage in municipal advisory activities for a municipal entity or obligated person.'' In response to the Second Request for Comment, Columbia Capital objected to the deletion of ''engages'' from the definition of ''municipal advisory relationship'' in subsection (f)(vi) of the Revised Draft Rule. Specifically, Columbia Capital stated that, ''[i]f a person provides 'advice' he/she should trigger the [municipal advisor] duties at the time of providing that advice and should be considered [a municipal advisor] unless that person qualifies for an exemption or exclusion at the time such advice is provided.'' Under the proposed rule change, the municipal advisory relationship would begin at the time a municipal advisor enters into an agreement to engage in municipal advisory activities, which then triggers the documentation requirements of Proposed Rule G–42(c).

The MSRB believes Columbia Capital's concern is moot because the other duties required by Proposed Rule G–42, including, but not limited to, providing written disclosures to clients, would be triggered when a municipal advisor engages in municipal advisory activities. The MSRB also notes that engaging in municipal advisory activities would subject a firm to municipal advisor registration requirements and any other legal requirements applicable to municipal advisory activities. Accordingly, the MSRB has not revised subsection (f)(vi) of the Revised Draft Rule, as incorporated into the proposed rule, in response to this comment.

Economic Analysis of Comments on Economic Implications of Proposed Rule

Economic Analysis—Cost of Compliance

Several commenters stated that the cost of complying with the proposed rule would be ''burdensome'' or ''significant.'' In some cases, commenters identified alternative approaches that they considered to be less costly. No commenter provided specific cost information or data that would support an improved estimate of the costs of compliance.

FSR and SIFMA both stated that the requirement on municipal advisors to provide disclosure of all material conflicts of interest including any of its affiliates that provides any advice, service, or product directly or indirectly related to performing municipal advisory activities would be burdensome, particularly for municipal advisors that are part of large financial conglomerates. Sanchez commented that a ''written statement'' would be less burdensome than ''written documentation'' when municipal advisors conclude that material conflicts of interest exist. FSR, SIFMA, and Sanchez commented that the detailed disclosure of disciplinary events material to the client's evaluation of the municipal advisor could be accomplished at a lower cost by allowing municipal advisors to reference the documentation provided to the SEC on Forms MA and MA–I. Columbia Capital requested that the MSRB consider allowing municipal advisors to use more than one document to meet the requirement for documentation of the municipal advisory relationship.

The MSRB agrees that municipal entities and obligated persons can be made aware of relevant conflicts of interest at a lower cost by revising some of the requirements. To that end, the MSRB amended Proposed Rule G–42(b)(i)(A) to narrow the scope of potential conflicts that would need to be disclosed from those that ''might'' impair the advisor's ability to provide advice to those that ''could reasonably be anticipated to impair'' the advisor's ability and Proposed Rule G–42(b)(i)(B) to remove the requirement to disclose potential conflicts that might arise from advice, service, or products provided by affiliates and *indirectly* related to the performance of municipal advisory activities. The MSRB also amended Rule G–42(b)(i) to allow for a written statement instead of written documentation if a municipal advisor concludes that no known material conflicts of interest exist. The MSRB also agrees that information regarding disciplinary events may be disclosed by identification of the specific type of the event and specific reference to the relevant portions of Forms MA and MA–I and has amended Proposed Rule G–42(b)(ii) to reflect this. Finally, the MSRB has clarified that a municipal advisor may use multiple documents to document the relationship by adding the plural ''writings'' to Proposed Rule G–42(c).

Economic Analysis—Transition Period

Lewis Young urged the MSRB to adopt a transitional period to permit advisors to honor their existing financial advisory agreements. They stated that many financial advisory agreements are longer-term arrangements and that advisors should be provided with a reasonable opportunity to conform existing arrangements to the requirements of the proposed rule when they are renewed or after a reasonable phase-in period after the rule is finalized. Zion also urges the MSRB to include a transitional provision to permit advisors to honor existing contracts, including many that are multi-year contracts. Zion notes the significant time, effort, and expense that would be involved to supplement or amend existing contracts with additional content and disclosure required by the proposed rule. Zion states that under particular state and/or local procurement laws, the alterations to existing agreements may reopen the request for proposal process for issuers to hire municipal advisors, requiring additional (and significant) time, effort, and expense.

The MSRB believes that the required disclosure can generally be accomplished without formal amendments and, therefore, that the costs imposed will be less significant than generally anticipated.

Economic Analysis—Burden on Small Municipal Advisors

MSRB did not receive any comments specific to the Dodd-Frank Act requirement that MSRB rules 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.[80]

Nonetheless, the MSRB has been sensitive to the potential impact of the requirements contained in Proposed Rule G–42. To that end, the MSRB has made efforts to minimize costs, particularly those that might be expected to disproportionately impact smaller firms. In addition to the amendments discussed above that will reduce compliance costs, the MSRB has made changes to proposals included in prior Requests for Comment such as clarifying the obligations owed by municipal advisors to obligated persons, narrowing the circumstances under which disclosures related to the municipal advisory relationship and compensation arrangements need to be made, and removing disclosure requirements related to professional liability insurance.

The MSRB acknowledges that there will be costs associated with complying with this proposed rule and that some municipal advisors, including smaller firms, may exit the market as a result. However, the MSRB believes the costs and burdens are limited to those necessary to meet the objectives of the rule, consistent with its statutory basis.

[80] *See* 15 U.S.C. 78*o*–4(b)(2)(L)(iv).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the **Federal Register** or within such longer period of up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an email to *rule-comments@sec.gov*. Please include File Number SR–MSRB–2015–03 on the subject line.

Paper Comments

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549.

All submissions should refer to File Number SR–MSRB–2015–03. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the MSRB. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–MSRB–2015–03 and should be submitted on or before May 29, 2015.

For the Commission, pursuant to delegated authority.[81]

Brent J. Fields,

Secretary.

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[81] 17 CFR 200.30–3(a)(12).