MSRB
Municipal Securities
Rulemaking Board

January 30, 2012

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Release No. 34-65918; File No. SR-MSRB-2011-09

Dear Ms. Murphy:

The Municipal Securities Rulemaking Board ("MSRB") submits this letter in response to Release No. 34-65918 (the "Order"), which instituted proceedings to disapprove File No. SR-MSRB-2011-09, a proposed rule change consisting of a proposed interpretive notice concerning the application of MSRB Rule G-17 (on conduct of municipal securities and municipal advisory activities) to underwriters of municipal securities (the "proposed rule change").

In the Order, the Securities and Exchange Commission ("Commission") stated that it believed that "the proposal raises concerns, among other things, as to whether the disclosures [that would be required by the proposed rule change] are appropriate and, if so, whether the disclosures are sufficiently balanced to protect investors and municipal entities by assisting issuers and their advisors in evaluating underwriters and the transactions proposed by the underwriters without being overly burdensome for underwriters." The Commission also stated that it believed that "these concerns raise questions as to whether the MSRB's proposal is consistent with the requirements of Section 15B(b)(2)(C) of the [Securities Exchange] Act, including whether the disclosures outlined in the notice would prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons facilitating transactions in municipal securities and municipal financial products, remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in general, protect investors, municipal entities, obligated persons, and the public interest."

Required Disclosures

The proposed rule change would require two basic types of disclosures: one regarding the role of the underwriter and its potential or actual material conflicts of interest and the other concerning the material financial risks and characteristics of financings recommended by the underwriter. The MSRB does not believe that either

1900 Duke Street, Suite 600
Alexandria, VA 22314-3412
p 703 797 6600
f 703 797 6700
www.msrb.org

type of disclosure is overly burdensome to underwriters. On the other hand, the benefits of such disclosures to issuers, investors, and the public interest could be substantial.

As to the first type of disclosure (the role of the underwriter and its actual or potential conflicts of interest), most of the disclosures that would be required by the proposed rule change would be capable of standardization. In fact, these disclosures could consist of the exact language provided in the proposed rule change, which follows:

(i) Municipal Securities Rulemaking Board Rule G-17 requires an underwriter to deal fairly at all times with both municipal issuers and investors;

(ii) the underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer;

(iii) unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests;

(iv) the underwriter has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable; and

(v) the underwriter will review the official statement for the issuer's securities in accordance with, and as part of, its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction.

Similarly, the disclosure requirement concerning the conflict of interest raised by contingent fee compensation could be satisfied by using the exact language provided in the proposed rule change: "[C]ompensation that is contingent on the closing of a transaction or the size of a transaction presents a conflict of interest, because it may cause the underwriter to recommend a transaction that is unnecessary or to recommend that the size of the transaction be larger than is necessary."

The MSRB can see no reasonable argument that the foregoing disclosures would be overly burdensome for underwriters.

In this first type of disclosure, only the required disclosures of potential or actual material conflicts of interest[1] would not be capable of standardization but, as described below, the MSRB considers such disclosures to be a key element in the prevention of fraudulent and manipulative acts and practices and the promotion of just and equitable principles of trade, so that any burden upon underwriters as a result of these required conflicts disclosures is far outweighed by the benefit to issuers, investors, and public interest.

The MSRB believes that commenters have greatly overstated the burden on underwriters associated with the second type of disclosure that would be required by the proposed rule change (the material financial risks and characteristics of financings recommended[2] by the underwriter). First, in most cases, these disclosures would only be required in the case of complex municipal securities financings, such as those involving variable rate demand obligations ("VRDOs") or swaps. In the case of routine financings, such as fixed rate financings, the disclosures would only be required if the underwriter reasonably believed that the issuer personnel working on the financing lacked knowledge or expertise with such structures. In that case, the underwriter would be required to disclose the material aspects of such financings.

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1 In footnote 79 of the Order, the Commission staff said that the MSRB had not specifically responded to a letter from Peter C. Orr, CFA, President, Intuitive Analytics LLC, dated December 7, 2011, which was submitted after MSRB Response Letter II. We note that Mr. Orr had discussed the substance of his comment with MSRB staff before filing it and that the following language from MSRB Response Letter II was intended to respond to Mr. Orr's concern:

> [T]he MSRB wishes to make clear that the third-party payments to which the disclosure requirement under the Proposal would apply are those that give rise to actual or potential conflicts of interest and typically would not apply to third-party arrangements for products and services of the type that are routinely entered into in the normal course of business, so long as any specific routine arrangement does not give rise to an actual or potential conflict of interest.

2 We note that, if an underwriter merely executed a transaction already structured by the issuer and/or its financial advisor, so that the underwriter did not recommend the financing, this provision of the proposed rule change would not apply.

Even the disclosures concerning complex municipal securities financings would, in many cases, lend themselves to a considerable amount of standardization.[3] As an illustration, most VRDOs are structured in a similar manner. There are well known material financial risks associated with VRDOs that do not change from transaction to transaction. For example, when an expiring letter of credit is drawn upon to redeem VRDOs, the letter of credit bank will typically require repayment by the issuer within a short period of time, known as a "term-out." Issuers in such circumstance face the risk that they will neither be able to find an affordable substitute letter of credit nor be able to refinance with fixed rate debt. If they have an interest rate swap on the VRDOs, they also face the risk that refinancing the VRDOs with fixed rate debt will trigger a substantial termination payment to the swap provider, depending upon market conditions. Standardized disclosures can be developed to describe these and other common material financial risks and characteristics. Those disclosures would then only need to be modified in the event of variants in these structures proposed by the underwriter.

Surely there will be an initial cost of developing this second type of disclosure and updating it as structures change. As stated in the MSRB's letter to the Commission dated December 7, 2011, "The MSRB concedes that some underwriters may bear up-front costs in creating basic frameworks for the required disclosures for the various types of products they may offer their issuer clients, but the on-going burden should thereafter be considerably reduced and the preparation of written disclosures would become an inter-related component of the necessary documentation of the transaction." However, as discussed below, any burden on the underwriter of developing such disclosures would be far outweighed by the benefit to issuers, investors, and the public interest.

Benefits of Required Disclosures

Conflicts Disclosures. As to the requirement of the proposed rule change that the underwriter disclose potential or actual material conflicts of interest, the MSRB believes it is essential that issuers and their advisors understand the conflicts of interest that might color underwriter recommendations. Municipal securities offerings borne of self-interested advice or in the context of conflicting interests or undisclosed payments to third parties are much more likely to be the issues that later experience financial or legal stress or otherwise perform poorly as investments, resulting in significant harm to investors and issuers, including increased costs to taxpayers. In particular, in adopting its Rule G-37 and former Rule G-38, the MSRB established disclosure obligations

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[3] The MSRB wishes to emphasize that by "standardized disclosure" it does not mean boilerplate. As the proposed rule change would require, "Disclosures must be made in a manner designed to make clear to such official the subject matter of such disclosures and their implications for the issuer." Page after page of complex legal jargon in small print would not satisfy this requirement.

designed to address practices that could distort the process by which state and local government business is awarded and, therefore, could undermine a free and open market in municipal securities and the integrity of and public confidence in this market. Further, in proposing a series of rule changes relating to the fiduciary obligations of municipal advisors and the fair practice duties of municipal advisors and underwriters, the MSRB would require such municipal advisors and underwriters to make conflict-related disclosures to municipal entities and obligated persons.[4]

In recent years, a series of state and federal proceedings involving, among other things, undisclosed third-party payments in connection with new issues of municipal securities or closely-related transactions have been instituted, with the practices described in these proceedings presenting significant challenges to the integrity of the municipal market. In at least one case, such undisclosed third-party payments allegedly occurred in connection with activities that may have contributed to the largest municipal bankruptcy in United States history in Jefferson County, Alabama.[5] In addition, the United States Department of Justice, the Commission, and the attorneys general of a number of states have pursued a number of criminal and civil cases involving, among other things, alleged fraudulent activities relating to municipal securities offerings and closely-related transactions in which undisclosed third-party payments have played an important role in carrying out the allegedly fraudulent activities.[6]

Disclosures Relating to re Recommended Financings. The financial press has published extensive coverage of state and local government issuers that entered into interest rate swaps, allegedly based on the understanding that the swaps would remove the interest rate risk on their VRDOs only to find that the deteriorating credit quality of the monoline insurers and significant changes in the historical relationship between LIBOR and the SIFMA swap index rendered what had been marketed to them by some

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4 *See* MSRB Notice 2011-36 (Aug. 2, 2011); MSRB Notice 2011-48 (Aug. 23, 2011); MSRB Notice 2011-49 (Aug. 24, 2011); MSRB Notice 2011-61 (Nov. 3, 2011); *but see* MSRB Notice 2011-51 (Sept. 12, 2011).

5 *See In re* J.P. Morgan Securities, Inc., Securities Act Release No. 9078, Exchange Act Release No. 60928 (Nov. 4, 2009); *see also* Congressman Spencer T. Bachus, "Federal Policy Responses to the Predicament of Municipal Finance," Cumberland Law Review, Vol. 40, No. 3, 2009-2010.

6 *See, e.g.*, United States Department of Justice, Press Releases: CDR Financial Products and Its Owner Plead Guilty to Bid-Rigging and Fraud Conspiracies Related to Municipal Bond Investments (December 30, 2011), *available at* http://www.justice.gov/opa/pr/2011/December/11-at-1719.html.

underwriters as an "effective hedge" ineffective in the current market.[7] Furthermore, those same issuers found that, if they wanted to terminate the swaps, they faced sometimes substantial termination payments to swap providers.[8] In the case of swaps entered into with Lehman Brothers, state and local government issuers faced such termination payments even though bankrupt Lehman Brothers was not even making payments on the swaps. Many state and local governments are now faced with extremely difficult choices regarding potential reductions in services and public sector employment in order to avoid defaulting on their debt.

Jefferson County, Alabama is a prime example of the significant practical negative consequences when financial risks of a huge debt portfolio of VRDOs and interest rate swaps in fact materialize.[9] Thousands of citizens have been laid off, major increases in sewer rates seem inevitable, and bankruptcy proceedings threaten bondholders with substantial losses. Although there is no assurance that the local officials would have made different decisions had they been fully informed in a timely manner of the serious risks of the financing plan that they pursued, they would have had the information necessary to better determine whether to enter into such risky transactions and would have been significantly more likely not to have embarked on a strategy with such negative consequences.

The MSRB respectfully submits that any burden on underwriters of preparing the risks disclosures that would be required by the proposed rule change is more than outweighed by the benefit to state and local government issuers of avoiding similar pitfalls in the future. The required disclosures should provide issuers and their advisors with valuable information with which to evaluate underwriter recommendations.

Moreover, what the proposed rule change would mandate is the implementation of what are only sound business practices. The MSRB understands that many investment bankers already make sure that their issuer clients understand what they are taking on when they decide to do complex financings. The fact that the disclosures that would be required by the proposed rule change are already in common use is another reason that the MSRB believes that underwriters would not be unduly burdened by requiring their production.

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7 *See, e.g.*, "Groups: Swap Dealers Trying to Weaken Rules Protecting States, Localities," *The Bond Buyer* (December 6, 2011); "A Call to Stop Swaps: Pennsylvania Plans Ban on Derivatives," *The Bond Buyer* (February 1, 2010).

8 *See, e.g.*, "Philadelphia Swaps Cost Taxpayer $331M: Report," *Bloomberg* (January 17, 2012); "Detroit May Face Huge Termination Fees for Swaps," *The Bond Buyer* (December 5, 2011); "Yet Another Troubled Swap," *The Bond Buyer* (April 2, 2009).

9 "Sewers, Swaps and Bachus," *The New York Times* (April 22, 2011).

Rule G-17 is the cornerstone of MSRB regulation. It is central to the MSRB's mandate in Section 15B(B)(2)(C) of the Exchange Act to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons facilitating transactions in municipal securities and municipal financial products, remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in general, protect investors, municipal entities, obligated persons, and the public interest.

As discussed in the proposed rule filing, "Rule G-17 precludes a dealer, in the conduct of its municipal securities activities, from engaging in any deceptive, dishonest, or unfair practice with any person, including an issuer of municipal securities. The rule contains an anti-fraud prohibition. Thus, an underwriter must not misrepresent or omit the facts, risks, potential benefits, or other material information about municipal securities activities undertaken with a municipal issuer. However, Rule G-17 does not merely prohibit deceptive conduct on the part of the dealer. It also establishes a general duty of a dealer to deal fairly with all persons (including, but not limited to, issuers of municipal securities), even in the absence of fraud."

The proposed rule change would address this dual nature of Rule G-17 in the context of the activities of underwriters in their relationships with issuers of municipal securities. While this comment letter has focused on the disclosures that would be required by the proposed rule change in view of the Commission's statements in the Order, the MSRB wishes to reiterate its statement concerning the statutory basis for the proposed rule change already set forth in its filing of November 10, 2012.

> The proposed rule change is consistent with Section 15B(b)(2) of the Exchange Act because it will protect issuers of municipal securities from fraudulent and manipulative acts and practices and promote just and equitable principles of trade, while still emphasizing the duty of fair dealing owed by underwriters to their customers. Rule G-17 has two components, one an anti-fraud prohibition, and the other a fair dealing requirement (which promotes just and equitable principles of trade). The Notice would address both components of the rule. The sections of the Notice entitled "Representations to Issuers," "Underwriter Duties in Connection with Issuer Disclosure Documents," "Excessive Compensation," "Payments to or from Third Parties," "Profit- Sharing with Investors," "Retail Order Periods," and "Dealer Payments to Issuer Personnel" primarily would provide guidance as to conduct required to comply with the anti-fraud component of the rule and, in some cases, conduct that would violate the antifraud component of the rule, depending on the facts and circumstances. The sections of the Notice entitled "Role of the Underwriter/Conflicts of Interest," "Required

Disclosures to Issuers," "Fair Pricing," and "Credit Default Swaps" primarily would provide guidance as to conduct required to comply with the fair dealing component of the rule.

The MSRB appreciates the opportunity to submit this comment letter. If you have any questions, please do not hesitate to contact me.

Sincerely,

Margaret C. Henry

Margaret C. Henry
General Counsel, Market Regulation