COMMENTS TO SEC REGARDING PROPOSED DEFINITION OF MUNICIPAL ADVISORS AS IT RELATES TO UNDERWRITERS

Introduction

These comments are directed to the Securities and Exchange Commission's proposed definition of municipal advisors in Release No. 34-63576 (Dec. 20, 1010), 76 FR 824, 832 (Jan. 6, 2011), as the proposal relates to underwriters.

The Commission has recognized appropriately that dealers are municipal advisors when they step beyond typical underwriting roles to provide advice to municipal entities and obligated persons regarding, among other things, investments and derivatives. These comments address additional facts and circumstances in which recognition of municipal advisor status is appropriate.

Dodd-Frank Act's Definition of "Municipal Advisor"

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), Section 15B of the Securities Exchange Act of 1934 (the "1934 Act") provides for the registration and regulation of "municipal advisors." Section 15B(4)(e) defines the term "municipal advisors" in part, as follows—

> **(4)** the term "municipal advisor"—
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> **(A)** means a person (who is not a municipal entity or an employee of a municipal entity) that—
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> **(i)** provides advice to or *on behalf of* a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; … [Emphasis added.]

Thus, taking into account the definition of "municipal financial products," Section 15B(4)(e) contemplates the regulation of the following persons with respect to municipal entities and obligated persons—

- Persons that provide advice with respect to the issuance of municipal securities

- Persons that provide advice with respect to guaranteed investment contracts and investment strategies

- Persons that provide advice with respect to municipal derivatives

Inclusion in the statutory definition of the phrase "on behalf of" with reference to interactions between municipal advisors, on one hand, and municipal entities or obligated persons, on the other, is significant and instructive. The phrase "on behalf of" indicates advice *for* another person and in their best interests, as contrasted with advice provided by a principal dealing solely at arms' length. The phrase should not be used casually, but rather in designating facts and circumstances in which underwriters may be considered to be municipal advisors when they step beyond typical underwriting roles, as defined in the Dodd-Frank Act by reference to the Securities Act of 1933 (the "1933 Act').

Section 15B(4)(e) of the 1934 Act provides the following exclusion from the definition of "municipal advisor"—

> **(C)** … a broker, dealer, or municipal securities dealer serving as an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933) (15 U.S.C. 77b(a)(11)) … .

Section 2(a)(11) of the 1933 Act defines the term "underwriter" in narrow terms, as follows—

> any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking … .

The 1933 Act's definition contains an excellent description of the arm's-length role of underwriters purchasing securities from issuers as principals in commercial buy-sell transactions ("any person who has purchased from an issuer with a view to … the distribution of any security"). The definition also includes "any person who … offers or sells for an issuer in connection with the distribution of any security." The latter arrangement, however, is not typical in the municipal securities market.

The 1933 Act's definition of "underwriter" says nothing about underwriters providing "advice" "on behalf of" municipal entities or obligated persons. The provision of "advice" extends beyond the scope of the 1933 Act's (and Dodd-Frank's) definition.

Commission's Proposal

In Release No. 34-63576 (Dec. 20, 1010), 76 FR 824, 832 (Jan. 6, 2011), the SEC proposed the following with respect to underwriters—

> **c. Exclusions From the Definition of "Municipal Advisor"**
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> **Broker, Dealer, or Municipal Securities Dealer Serving as an Underwriter**
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> The definition of "municipal advisor" in proposed rule 15Ba1–1(d) would clarify that the exclusion from the definition for a broker, dealer, or municipal securities dealer serving as an underwriter does not apply when such persons are acting in a capacity other than as an underwriter

on behalf of a municipal entity or obligated person. The Commission interprets the exclusion to apply solely to a broker, dealer, or municipal securities dealer serving as an underwriter *on behalf of* a municipal entity or obligated person in connection with the issuance of municipal securities. Thus, a broker, dealer or municipal securities dealer would not be excluded from the definition of a "municipal advisor" if the broker, dealer or municipal securities dealer engages in municipal advisory activities when acting in a capacity other than as an underwriter *on behalf of* a municipal entity or obligated person. For example, a broker-dealer advising a municipal entity with respect to the investment of bond proceeds or the advisability of a municipal derivative, would be a municipal advisor with respect to those activities.

In addition, a broker-dealer acting as a placement agent for a private equity fund that solicits a municipal entity or obligated person to invest in the private equity fund would be a municipal advisor with respect to that activity. The Commission notes that including such activities within the scope of municipal advisory activities is consistent with the Exchange Act.

One commenter asked for clarification regarding whether a broker-dealer or another entity that provides advice or assistance to a municipal entity on an informal non-contractual (and noncompensated) basis would have to register as a municipal advisor. This commenter believes that such persons should not have to register as municipal advisors. Another commenter, however, stated that "[a]ny advisor who provides 'free' service will be compensated at some point for this service. The services being rendered are the trigger for registration and the corresponding fiduciary duty, not the title of the relationship, the terms of the contract, or the compensation received. Such advisor should not be permitted to avoid registration and fiduciary responsibilities." Similarly, another commenter stated that individuals that offer "'free' or 'voluntary' Municipal Securities Advisory Services should not be exempt from registration."

In defining the term "municipal advisor" in Exchange Act Section 15B(e)(4), Congress did not distinguish between those municipal advisors who are compensated for providing advice and those who are not compensated for providing advice. Thus, consistent with Congress's definition of the term "municipal advisor," the Commission does not believe the issue of whether a municipal advisor is compensated for providing municipal advice should factor into the determination of whether the municipal advisor must register with the Commission. [Footnotes omitted, emphasis added.]

Linguistic Issue

The Commission's regulatory use of the phrase "on behalf of" in describing the actions of underwriters in relation to municipal entities or obligated persons is troublesome. Typically, underwriters, which have significant responsibilities to investors, do not function "on behalf of" municipal entities or obligated persons because underwriters are dealing as principals at arms'-length in commercial buyer-seller transactions. Those adverse relationships are directly inconsistent with functioning "on behalf of" municipal entities or obligated persons.

To emphasize the point: One who deals *solely* as a principal at arms'-length does not deal "on behalf of" the counterparty in the transaction.

While this may appear to some to be a linguistic matter, it is crucial in terms of characterizing appropriately the typical underwriter-issuer relationships. The Dodd-Frank Act used the phrase "on behalf of" in defining the term "municipal advisor," and as noted above, in excluding underwriters, referred *only* to the narrow 1933 Act definition of "underwriter," which does not itself refer to the provision of "advice."

Tens of thousands of infrequent or unsophisticated municipal securities issuers are easily confused, and are vulnerable, regarding the nature of their relationships with underwriters and regarding the appropriate role of underwriters. This is made more difficult because the governing bodies of elected officials commonly consist of everyday citizens—lay people who know virtually nothing about finance roles or practices. Additionally, there is a relatively high turnover rate among elected officials, so that even though an official may gain experience, that experience is easily lost. Some underwriters and other market professionals may not attempt to explain the nature of underwriter-issuer relationships to issuer officials.

Unfortunately, bond counsel, who often provide legal services to both dealers and issuers throughout the course of their legal practices, and who often work for contingent fees payable upon transactional closings, may decline to become involved in explaining to issuers the possibility of significant limitations on underwriters' "advice."

Moreover, some underwriters, on occasion, in communicating with vulnerable issuers may blur or confuse the parameters of the underwriting role explicitly or implicitly. This may occur especially at the outset of relationships when underwriters are seeking engagement. While the Commission has enforcement authority with respect to material misstatements made by underwriters to issuers, the Commission is limited in terms of budgets and staff, and has taken action to protect issuers in only a few such instances.

Municipal entities and obligated persons may believe naively, based upon underwriter representations, that underwriters are placing the entities' and persons' interests first and that the entities and persons are receiving advice from underwriters in the entities' and persons' best interests, when that is not the case.[1] The prevention of such misunderstandings is crucial to the Commission's attempts to improve municipal market practices because municipal entities and obligated persons may not be receiving or relying upon appropriate advice regarding their rights and responsibilities with respect to a range of matters, not the least of which is disclosure to investors.[2] This may occur especially when underwriters undertake to prepare issuer disclosure documents, either directly or through their underwriter counsel.

While underwriters also have disclosure responsibilities to investors, those responsibilities are interpreted differently from issuers' responsibilities. The Commission has stated that "[I]ssuers are primarily responsible for the content of their disclosure documents … ."[3] while underwriters are required to form reasonable bases for belief in key representations in officials statements.[4]

Market's & Commission's Policy Dilemma

Since the beginning of the financial crisis, during which it became graphically apparent that many issuers had an inadequate understanding of complex transactions into which they entered, and of their roles and responsibilities in those transactions, a number of market participants, and Commission personnel, have stated that perhaps issuers that could not understand the market and its practices should not engage in securities offerings to the public. Further, there is a growing practice of issuers accessing direct bank loans to minimize costs. Such loans often avoid entirely the involvement of underwriters.

I believe that, in many cases, direct loans are useful for issuers. On the other hand, when issuers cannot pay the typical 10-, 15- or perhaps 20-year amortizations that direct lenders require, the issuers must, by necessity, enter the securities market. They cannot fund much public infrastructure otherwise. I am certain the Commission would not wish to adopt market structures, or to approve market practices, that will have the practical

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[1] Underwriters earn their profits or compensation only by closing transactions. That reality gives underwriters a "deal focus" that conflicts with the appropriate focus and best interests of municipal entities and obligated persons. The best interests of municipal entities and obligated persons requires that they complete transactions that are sound for them, regardless of professional compensation generation, and that they make appropriate disclosure to investors, even if it may make securities more difficult for underwriters to sell.

[2] When underwriters prepare issuer disclosure documents, directly or through underwriter counsel, the facts and circumstances may be misconstrued even more readily.

For example, underwriters commonly provide information for use in official statements that many issuers may not be equipped to double-check and for which issuers must rely upon the underwriters for accuracy and completeness. That information includes, among other things, calculations of debt payment schedules, maturity schedules, interest rates and yields, and debt service coverage projections.

[3] SEC Rel. No. 34-26100, 53 F.R. 37778, 28811 n.84 (July 10, 1989).

[4] SEC Rel. No. 34-26100, 53 F.R. 37778 (Sept 28, 1988), and SEC Rel. No. 34-26985, 54 F.R. 28799 (July 10, 1989).

ultimate consequence of excluding tens of thousands of local governments from the securities market.

I submit respectfully that Dodd-Frank's "municipal advisor" concept is a vehicle by means of which issuers will be able to receive the professional financial guidance they need, so that they are able to remain comfortably in the market. In terms of numbers, such a corps of municipal advisors must be grown, regulated and trained appropriately, but if the Commission makes it a key goal to facilitate those developments, then the interests of both issuers and investors will be enhanced. It then will be possible for unsophisticated issuers to remain in the market because there will be appropriate professional guidance available to assist them and directed to placing their interests first. Underwriters that fail to focus upon issuers' best interests cannot fill such a role.

Additional Facts & Circumstances

I suggest respectfully that the Commission also speak to facts and circumstances in which dealers that may be serving as underwriters, as defined narrowly in Section 2(a)(11) of the 1933 Act, serve in additional roles, in relationships of trust and confidence with municipal entities or obligated persons, when those roles depart from the typical underwriting role of principals dealing *solely* at arms'-length in commercial buyer-seller transactions, such as—

- Providing advice while serving as agents, within the scope of the agency relationships

- Providing advice regarding cash flows or other projections of revenues or expenses (as distinguished from routine debt service calculations based upon stated assumptions, as relevant to structure and terms of securities) or advice regarding the feasibility of projects or programs

- Providing assistance or advice in negotiating key agreements, especially credit agreements with third parties upon which municipal entities or obligated persons rely in conjunction with municipal securities issues

- Providing advice and inducing reliance by municipal entities and obligated persons upon that advice without informing the municipal entities' or obligated persons' policy makers that the underwriters are not proffering the advice in a fiduciary capacity placing the municipal entities' or obligated persons' interests first or as to the municipal entities' or obligated persons' best interests

Specifically, as discussed below, I suggest respectfully that the Commission also speak to important facts and circumstances in which an underwriter may provide advice or services to an issuer in a relationship of trust and confidence regarding "the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such … issues" as used Section 15B(4)(e)'s definition of municipal advisor.[5]

I note again that the exemption for underwriters from the definition of "municipal advisor" is quite narrow, namely, facts and circumstances in which underwriters only "purchase[] from an issuer with a view to, or offer[] or sell[] for an issuer in connection with, the distribution of any security," or participate in such an undertaking. Section 2(a)(11) says nothing whatsoever about underwriters providing "advice" or "services" to municipal entities or obligated persons

Unless the Commission recognizes and implements in an appropriate manner the narrow character of the underwriter definition referenced in the Dodd-Frank Act, the Commission will be diminishing otherwise important protections for municipal entities and obligated persons provided in that Act. That will discourage municipal entities and obligated persons from seeking and obtaining appropriate advice upon which the

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[5] The MSRB is proposing an interpretation under Rule G-23 that would treat dealers as financial advisors in certain facts and circumstances despite providing such "advice." Among other things, the interpretation states—

> For purposes of Rule G-23, a dealer that provides advice to an issuer with respect to the issuance of municipal securities will be presumed to be a financial advisor with respect to that issue. However, that presumption may be rebutted if the dealer clearly identifies itself as an underwriter from the earliest stages of its relationship with the issuer with respect to that issue. Thus, a dealer providing advice to an issuer with respect to the issuance of municipal securities (including the structure, timing, and terms of the issue and other similar matters, such as the investment of bond proceeds, a municipal derivative, or other matters integrally related to the issue) generally will not be viewed as a financial advisor for purposes of Rule G-23, if such advice is rendered in its capacity as underwriter for such issue. Nevertheless, a dealer's subsequent course of conduct (*e.g.*, representing to the issuer that it is acting only in the issuer's best interests, rather than as an arm's length counterparty, with respect to that issue) may cause the dealer to be considered a financial advisor with respect to such issue. In that case, the dealer will be precluded from underwriting that issue by Rule G-23(d).

That proposal is a positive contribution. I believe, however, that the penultimate sentence should not contain the words "subsequent" or "only." It is possible that a dealer may make representations or engage in conduct *at the very outset of a relationship* that leads a municipal entity or obligated person to believe the dealer, even though labeled" underwriter," is providing such advice in the municipal entities' or obligated persons' best interests.

Moreover, the "advice" may have additional subsidiary, incidental or other functions in addition to being offered in an issuer's best interests. Thus, the use of the word "only" is excessively restrictive.

In addition, in the parenthetical statement in that sentence, I suggest adding the following after "representing to the issuer": ", or making other statements or engaging in conduct leading the issuer to believe,". Even if a direct explicit representation is not made, there are a variety of words and conduct that may lead vulnerable municipal entities and obligated persons to believe that an underwriter's advice places their interests first and is provided in their best interests.

The sentence, as so modified, would read: "Nevertheless, a dealer's course of conduct (*e.g.*, representing to the issuer, or making other statements or engaging in conduct leading the issuer to believe, that the dealer is acting in the issuer's best interests, rather than as an arm's length counterparty, with respect to that issue) may cause the dealer to be considered a financial advisor with respect to such issue."

municipal entities and obligated persons are entitled to rely as placing their interests first and as proffered in their best interests.

In turn, that will lead to the conduct of inappropriate securities issues, and potentially to less than stellar disclosure, to the disadvantage of investors.

In the municipal securities market, it is especially critical to encourage the tens of thousands of infrequent and unsophisticated issuers, many of whom fail to comprehend adequately their full municipal securities responsibilities, to receive and rely upon appropriate advice. Underwriters, as principals dealing solely at arms'-length and focused upon contingent profits or compensation payable only at closing, are not in a suitable posture to provide such advice.

Agency

Although it is unusual, some underwriters, at times, do promise to issuers that the underwriters will "represent" or serve "on behalf of" the municipal entities in financial or other aspects of municipal securities transactions or will serve otherwise as issuers' agents. This has occurred even at the outset of relationships and even simultaneously with labeling of a dealer as an "underwriter." When that occurs, the underwriters are undertaking to act for and on behalf of the issuers in dealings with third parties.

Many municipal entities are confused easily by the mixed messages. Municipal entities often do not recognize that dealers' use of the term "underwriter" has a special unstated technical meaning that is unknown to the municipal entities.

I respectfully suggest that the Commission recognize that such agency relationships are outside the typical underwriting role and that those relationships entail fiduciary duties. See, *e.g.*, the **RESTATEMENT (THIRD) AGENCY** §1.01, stating—

§1.01 Agency Defined

> Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.

The **RESTATEMENT** makes abundantly clear in multiple provisions that agents are obligated to serve and provide information within the scope of the agency in their principals' best interests. Among other things, the **RESTATEMENT** §8.01, states—

> An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship.

See also **RESTATEMENT (THIRD) AGENCY** §8.11, stating—

> **§8.11 Duty To Provide Information**
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> An agent has a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know when
>
> > (1) subject to any manifestation by the principal, the agent knows or has reason to know that the principal would wish to have the facts or the facts are material to the agent's duties to the principal[.]

The **RESTATEMENT** §8.06 requires disclosure of an agent's conflicts of interest. A commentary in the **RESTATEMENT** states—

> Under the rule stated in §8.06, the agent has a duty to deal fairly with the principal and to disclose to the principal all facts of which the agent has notice that are reasonably relevant to the principal's exercise of judgment, unless the principal has manifested that the principal already knows them or does not wish to know them. Thus, a principal's knowledge that its agent acts as or on behalf of an adverse party does not convert the relationship between principal and agent into an arm's-length relationship.

There is ample authority recognizing such principles with reference to underwriters. Judicial precedent recognizes that an agency relationship gives rise to fiduciary duties, even when a dealer may have served the issuer as an underwriter. *See SEC v. Cochran*, 214 F.3d 1261, 1265, 1266 (10^{th} Cir. 2000), in which the Court stated with reference to an underwriter that served as an issuer's agent and advisor in connection with investments—

> When one party expressly or implicitly agrees to act as an agent or broker on behalf of another party, Oklahoma law imposes on the agent a fiduciary duty to disclose to the principal all material facts within the scope of the agency.

See also Fippinger, **THE SECURITIES LAW OF PUBLIC FINANCE** (2d ed. vol. I Practising Law Institute, NY 2009), §8.11.5 at 8-184, 8-186, stating—

> Generally, a broker, who is an agent acting on behalf of a customer, is considered a fiduciary of the customer. [Footnote omitted.]
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> * * *
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> The distinction between a broker and a dealer under the 1934 Act's section 3(a)(4) and (5) definitions is that a broker acts as an agent for its customer and a dealer acts as a principal. An agent is ordinarily a fiduciary to the agent's principal … . [Footnote omitted.]

Mr. Fippinger discusses certain decisions and actions in the municipal securities market, such as the *Cochran* decision, relating to duties of underwriters, concluding—

> The line of cases … suggest that an investment banking firm's status in a transaction may change. A firm may begin in an arm's-length relationship as principal to principal but engage in conduct that makes it reasonable for the other party to believe the firm has become its agents. Likewise, a fiduciary relationship can end and a principal-to-principal relationship commence, or, the fiduciary relationship may be deemed to continue despite the existence of dealer activity that customarily does not involve a fiduciary relationship. [6]
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> Fippinger, **THE SECURITIES LAW OF PUBLIC FINANCE** (2d ed. vol. I Practising Law Institute, NY 2009), §8.11.6 at 8-193 to 8-194.

The Ninth Circuit applied California law to an investment banking firm advising a private company in *In re Daisy Systems Corp.*, stating: "Should a factfinder determine from the record that an agency relationship existed between the parties, … then a fiduciary relation should be presumed to exist." *In re Daisy Systems Corp.*, 97 F.3d 1171, 1178-79 (9th Cir. 1996).

Mr. Fippinger offers sound practical advice regarding clarifications to avoid such possibilities—

> The practical implication is that the parties should contractually clarify the status of the firm and whether it will change during the course of a transaction.
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> Fippinger, **THE SECURITIES LAW OF PUBLIC FINANCE** (2d ed. vol. I Practising Law Institute, NY 2009), §8.11.6 at 8-194.

<u>Cash Flows & Other Financial Projections</u>

Again, although it is unusual, some underwriters, at times, do promise to municipal entities or obligated persons that the underwriters will analyze various revenue or expense cash flows, or project or program feasibility, for the municipal entities or obligated persons. As the Government Finance Officers Association ("GFOA") states in a Best Practice, discussed below, such "services" are also outside the typical underwriting role.

In its Rule G-23, the Municipal Securities Rulemaking Board ("MSRB") provides that a dealer serving as an underwriter is not subject to the Rule's requirements of resignation as a financial advisor if the dealer, as underwriter, "renders advice to an

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[6] See also §8.11.5 at 8-184, stating—

> Generally, a broker, who is an agent acting on behalf of a customer, is considered a fiduciary of the customer. [Footnote omitted.]

issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities."[7]

Those are limited categories of "advice." Rule G-23 provides that underwriters may provide such advice "*to*" issuers, while it describes financial advisors as providing closely similar, although somewhat broader, categories of "advice" in the form of "*services to or on behalf of an issuer*."

Such distinctions are instructive. See, for example, the Government Finance Officers Association's ("GFOA") "Best Practice—Selecting Underwriters for Negotiated Bond Sales" (2008), stating "A negotiated bond sale does not entail the purchase of any goods or services by an issuer from an underwriter."

Rule G-23 does not contain the MSRB's only definitions of the terms "underwriter" and "financial advisor." The MSRB's **GLOSSARY** echoes the 1933 Act's narrow concept of an "underwriter," and contains a broader definition than Rule G-23 of the term "financial advisor" that adds "A financial advisor may also be employed to provide advice on subjects unrelated to a new issue of municipal securities, *such as advising on cash flow* and investment matters." Such language as to advice regarding cash flows is omitted from Rule G-23's or the MSRB's **GLOSSARY'S** (or the 1933 Act's) descriptions of appropriate underwriting roles.

Indeed, the preparation of cash flow projections or analyses, or feasibility analyses, are "services" that lie entirely outside the types of securities structuring "advice," or what GFOA describes in another Best Practice discussed below as "ideas and suggestions," that underwriters, serving solely as arms-length principals, would or should provide to issuers in the course of functioning as underwriters. Projections of revenues or expenses are distinctly different from debt service schedules that are integral to the structuring of municipal securities and that are calculations of principal and interest based upon stated assumptions relating to securities structures.

Negotiation of Key Agreements

Another unusual "service" that some underwriters may provide to municipal entities or obligated persons outside of the typical underwriting role is to assist and advise in the negotiation of key agreements, especially key credit agreements with third parties upon which issuers may rely in entering into municipal securities transactions.

For example, a municipal entity may issue general obligation bonds to fund a loan to a private company developing a start-up operation in an economic development project. A dealer labeled as an "underwriter" may promise to assist the municipal entity with respect to development of the agreement between the entity and the company and to advise the entity regarding associated risks.

Thus, although it is unusual, underwriters may serve as intermediaries between the municipal entities or obligated persons and third parties, or may promise to provide

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[7] See the earlier footnote discussing a draft MSRB interpretation regarding this language.

advice relating to risks inherent in various formulations of those agreements and means of mitigating or avoiding the risks. Such "advice" has the appearance of placing the issuers' interests first, but may be self-serving attempts to move transactions forward so as to collect contingent fees.

As with agency "services," the provision of revenue and expense projections or analyses, or analyses regarding project or program feasibility, such a "service" departs substantially from the typical arm's-length role of underwriters dealing solely as principals with municipal entities or obligated persons in commercial buy-sell transactions.

Advice Inducing Issuer Reliance

In its proposal, the Commission stated—

> For example, a broker-dealer advising a municipal entity with respect to the investment of bond proceeds or the advisability of a municipal derivative, would be a municipal advisor with respect to those activities.

Thus, the Commission recognized that certain, but not all, advice contemplated to be provided to municipal entities or obligated persons would cause a dealer to be a "municipal advisor." The Commission failed, however, to include within that recognition "advice" provided regarding "the issuance of municipal securities," which also is in the Dodd-Frank definition of "municipal advisor."

I do not argue that dealers serving as underwriters should not be able to provide "advice" of any character (or what GFOA characterizes as "ideas and suggestions") to municipal entities or obligated persons, so long as vulnerable municipal entities and obligated persons are not induced under then-prevailing facts and circumstances to perceive that "advice" as offered in the municipal entities' or obligated persons' best interests or as placing their interests first. When, however, the prevailing facts and circumstances, including the communications and conduct of underwriters, lead municipal entities or obligated persons to rely inappropriately upon the underwriters' "advice" in relationships of trust and confidence, then underwriters that have caused such reliance should be regarded as municipal advisors.

A key distinction is between the provision of advice "*to*" municipal entities and obligated persons versus the provision of advice "*on behalf of*" those entities and persons. Municipal Securities Rulemaking Board ("MSRB") Rule G-23, for example, contains such a distinction, as discussed below. To some, the distinction may appear to be esoteric, but the substance of that distinction is real and entails far-reaching implications for achievement of desirable improvements in municipal securities market practices.

To state it more concisely, allowing underwriters to provide unfettered, atypical, "advice" "*on behalf of*" municipal entities and obligated persons would create a crack in the municipal advisor regulatory pattern through which disadvantageous "advice" could be provided to the municipal entities and obligated persons. It would offer a potential path for exploitation, and in more extreme instances, deception, of municipal entities and obligated persons.

I suggest respectfully that there are certain facts and circumstances in which underwriters providing "advice" "on behalf of" municipal entities or obligated persons should be subject to the federal fiduciary standard, the special federal antifraud provision, professional standards, and other aspects of municipal advisor regulation. Although, once again, it is atypical underwriting practice, some underwriters may suggest through words or conduct to the municipal entities or obligated persons, even at the outset of relationships and even while using the label "underwriter," that the underwriters are placing the entities' or persons' interests first or are acting reliably in the entities' or persons' best interests and may advise the entities or persons as to the financial decisions the entities or persons should make.

A substantial danger is that some underwriters may use the proposed exception from municipal advisor status to induce tens of thousands of vulnerable infrequent and unsophisticated municipal securities issuers to rely upon the underwriters for advice when the issuers do not understand that the underwriters' unstated posture is that the underwriters do not have a fiduciary duty to the issuers to provide advice placing the issuers' interests first or as to the issuers' best interests.

That is not merely a possibility. It does actually occur, even if it is unusual, and it directly inhibits satisfaction of the critical need for municipal securities issuers to receive sound advice regarding the transactions into which they enter. Those best interests include the issuers' appropriate fulfillment of their disclosure responsibilities.

Now that the Dodd-Frank statutory structure is in place, and the regulatory structure is beginning to take shape, I submit respectfully that the Commission should encourage municipal entities and obligated persons to seek appropriate advice from regulated municipal advisors who are subject to the fiduciary duty and other aspects of municipal advisor regulation. When municipal entities or obligated persons rely upon inappropriate advice that is not in their best interests, that advice may supplant the advice the entities and persons should receive. Further, it may lead to the conduct of transactions that should not be conducted and to faulty disclosure to investors (especially when underwriters or their counsel prepare official statements).

It is not difficult for underwriters to avoid any misunderstandings as to the character of their advice. For example, echoing Robert Fippinger's sound advice that "the parties should contractually clarify the status of the [dealer] firm," the Securities Industry and Financial Markets Association ("SIFMA") stated in its "Bond Purchase Agreement—Governmental Tax- or Revenue-Supported Securities—Instructions and Commentary" (9/17/08), as follows—

> *Commentary*: Section 3 of the BPA Terms and Acceptance (second paragraph) clarifies the nature of the relationship under the Agreement between the Underwriters and the Issuer. In particular, that language confirms that the Underwriters and the Issuer are acting on an arm's-

> length, commercial basis and that *no Underwriter is acting as a fiduciary or agent of the Issuer*. This paragraph *should be discussed* with the Senior Manager and the Issuer. *If the relationship between the Issuer and an Underwriter differs from that described in the paragraph, the language in that paragraph should be modified or deleted as appropriate*. [Emphasis added.]

SIFMA, therefore, recommended two important and constructive steps for dealers serving as underwriters—

- Explicit discussion with issuers underscoring the nonfiduciary character of typical underwriter-issuer relationships; and
- Explicit recognition in bond purchase agreements of atypical facts and circumstances in which underwriters do assume fiduciary roles.

SIFMA itself recognized that underwriters may have fiduciary duties to issuers ("If the relationship between the Issuer and an Underwriter differs from that described in the paragraph").

I submit respectfully that SIFMA's language presents a workable methodology through which underwriters may avoid a fiduciary duty. I suggest respectfully that the Commission adopt those views.

Of course, the explicit discussions should occur with a municipal entities' or obligated person's policy makers and should entail explanation of important consequences of the nonfiduciary character of typical underwriter-issuer relationships. In that vein, the discussions should clarify that underwriters' "advice" is not proffered placing the entities' or persons' interests first or in their best interests.

In addition, the discussions should occur at the outset of the relationships and, in any event, prior to the time that municipal entities or obligated persons commit themselves to particular courses of action, such as committing them to engage the dealers as underwriters or to particular forms of transactions or plans of finance.

As another example of market views regarding underwriters' roles and responsibilities, in a "Best Practice—Selecting Underwriters for Negotiated Bond Sales" (2008), GFOA describes the underwriting role in narrow terms corresponding to the definition of "underwriter" in Section 2(a)(11) of the 1933 Act (to which Dodd-Frank refers)—

> State and local governments select underwriters *for the purpose of selling bonds* through a negotiated sale. *The primary role of the underwriter in a negotiated sale is to market the issuer's bonds to investors*. Assuming that the issuer and underwriter reach agreement on the pricing of the bonds at the time of sale, the underwriter purchases the entire bond issue from the issuer and resells the bonds to investors. In addition, negotiated sale underwriters are likely to provide *ideas and*

> *suggestions* with respect to structure, timing and marketing of the bonds being sold. [Emphasis added.]

GFOA, then, sees underwriters *primarily* as purchases of issuers' bonds, and does not view underwriters as providing "advice" to issuers, but rather "ideas and suggestions." Only when viewing underwriters as so defined in narrow terms corresponding to the definition in the 1933 Act (and Dodd-Frank) to have the "primary role" of "market[ing] the issuer's bonds to investors," GFOA states that underwriters do not have fiduciary duties to issuers—

> Issuers must keep in mind that the roles of the underwriter and the financial advisor are separate, adversarial roles and cannot be provided by the same party. Underwriters do not have a fiduciary responsibility to the issuer. A financial advisor represents only the issuer and has a fiduciary responsibility to the issuer. …

GFOA adds in its Best Practice that "A negotiated bond sale does not entail the purchase of any goods or services by an issuer from an underwriter."

Some in the market see underwriters' roles as broader than does GFOA. This confusion can (and does) work to the significant disadvantage of vulnerable municipal entities and obligated persons.

Without explicit discussions as recommended by SIFMA, tens of thousands of less sophisticated or unsophisticated municipal securities issuers will continue to be placed at significant risk of misunderstanding the character of their relationships with underwriters.

When, despite relying upon underwriters' advice, the issuers learn that, in unusual facts and circumstances, some underwriters may have had conflicts of interest with the issuers or may have withheld information or provided flawed advice that was not in the issuers' best interests, the issuers may lack an effective remedy because litigation to enforce a state fiduciary duty may be excessively costly and burdensome. Underwriting firms, on the other hand, typically are vastly better capitalized and able to engage in complex and lengthy litigation. The clearly articulated federal fiduciary duty and the federal antifraud provision for municipal advisors, together with enhanced Commission enforcement, would assist in overcoming such difficulties.

Although certain underwriter advocates are vocal in asserting that underwriters cannot have a fiduciary duty to issuers or obligated persons,[8] SIFMA's Model Bond

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[8] Ardent arguments advanced by representatives of the investment banking industry in the heat of lobbying activities regarding legislation or regulation should be recognized for what they are. Such arguments are directly at odds with SIFMA's statement of industry practices in connection with its Model Bond Purchase Agreement.

For example, Michael Decker (Managing Director and Co-head of Municipal Securities at SIFMA) argued in a "Commentary—Fiduciary Duty 'Reform' Measures Would Hurt Market" BondBuyer.com (May 13, 2010), as follows—

Purchase Agreement directly contradicts such arguments, as do other market publications and judicial decisions. Those authorities recognize that certain facts and circumstances, however unusual, in which underwriters may provide advice to issuers may result in the imposition of a fiduciary duty upon underwriters.

For example, in their book on **BROKER-DEALER LAW AND REGULATION**, Norman Poser and James Fanto discuss the question of a fiduciary duty of investment bankers as "a highly relevant one today." They proceed to enumerate and discuss a number of instances in which investment bankers have been held to have fiduciary duties to issuers in underwriting and other capacities. N. Poser & J. Fanto, **BROKER-DEALER LAW AND REGULATION**, Vol. 2, Part C, Ch. 16, §§16.01-.03, especially §16.02[J] (Aspen Publishers, Frederick, MD 4th ed. 2010).

Similarly, as noted above, Robert Fippinger stated in **THE SECURITIES LAW OF PUBLIC FINANCE—**

> A firm may begin in an arm's-length relationship as principal to principal but engage in conduct that makes it reasonable for the other party to believe the firm has become its agents. … The practical implication is that the parties should contractually clarify the status of the firm and whether it will change during the course of a transaction.
>
> Fippinger, **THE SECURITIES LAW OF PUBLIC FINANCE** (2d ed. vol. I Practising Law Institute, NY 2009), §8.11.6 at 8-193 to 8-194.

> A fiduciary duty is an appropriate standard for certain financial relationships between parties, but not all. …
>
> [I]n the context of transactions between institutional counterparties, such as negotiated municipal bond underwriting or swap contracts, such a standard is unworkable.
>
> * * *
>
> These relationships by definition contradict the idea of being a fiduciary. Such a contradiction, if written into law, would create unmanageable legal uncertainty and risk. The implications of imposing a fiduciary duty where it does not apply could be quite severe. Broker-dealers would not be able to serve as underwriters on negotiated transactions.

Michael Nicholas (Chief Executive Officer, Bond Dealers Association) argued likewise in a "Commentary—Think Carefully Before Legislating Fiduciary Duty" (BondBuyer.com May 17, 2010), as follows—

> [C]learly, imposing fiduciary duties on a party with whom you are negotiating an arm's length transaction … is wrong and flies in the face of what a fiduciary relationship is all about.

Mr. Fippinger described facts and circumstances in which such a result is possible, as follows—

> A dealer will only be considered a fiduciary if particular facts and circumstances indicate that a customer has transferred power to the dealer encumbered with fiduciary obligations.
>
> Fippinger, **THE SECURITIES LAW OF PUBLIC FINANCE** (2d ed. vol. I Practising Law Institute, NY 2009), §8.11.5 at 8-184.

In its Rule G-23, the Municipal Securities Rulemaking Board ("MSRB") provides that a dealer serving as an underwriter is not subject to the Rule's requirements associated with resignation as a financial advisor if the dealer, as underwriter, "renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning a new issue of municipal securities."[9]

Rule G-23, however, makes no effort to describe the consequences of an underwriter's having provided such advice and defers to state law. See, *e.g.*, remarks of Diane Klinke (MSRB General Counsel) regarding Rule G-23 at the SEC's 2000 Municipal Market Roundtable, recognizing the potential for a fiduciary duty on the part of underwriters, even if unusual—"[I]n my view, fiduciary status is a state law question. It depends on the facts and circumstances of the arrangement. So even though I believe most underwriters would say in the course of their underwriting activities they are not fiduciaries, anyone could find anyone to be a fiduciary depending on the facts and circumstances, you could have a review." and "What they do may cause them to be a fiduciary given facts and circumstances, most of the time … most underwriters would view themselves not as a fiduciary."

Judicial authority takes much the same tack as do market publications. In the *Cochran* decision, noted above, the Tenth Circuit stated, in applying Oklahoma law to an investment banking firm that, while serving as underwriter to an issuer, also advised the issuer allegedly without disclosure of important information regarding investments of the proceeds of bond issues:

> When one party expressly or implicitly agrees to act as an *agent or broker on behalf of* another party, Oklahoma law imposes on the agent a fiduciary duty to disclose to the principal all material facts within the scope of the agency.
>
> * * *
>
> Although there is no explicit evidence of Cochran's consent to act as the PCDA's fiduciary in obtaining a GIC [guaranteed investment contract], the record supports an inference that Cochran assented by acting as an *advisor*

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[9] See the earlier footnote discussing a draft MSRB interpretation regarding this language recognizing that a dealer providing such advice may, under certain facts and circumstances, be both an underwriter and a financial advisor, which would violate the rule.

> *and agent* in the GIC transaction. Based on that evidence, a reasonable juror could conclude that, under Oklahoma law, a relationship of trust and confidence existed between Cochran and the PCDA that gave rise to a duty to disclose all material facts related to the purchase of the GIC. …
>
> *SEC v. Cochran*, 214 F.3d 1261, 1265, 1266 (10th Cir. 2000). [Emphasis added.]

In *Union County, Iowa v. Piper Jaffray & Co., Inc.*, Case No. 4:06-cv-374 (SD Iowa Sept. 29, 2010), despite the Court's belief that a municipal entity's claim of an underwriter's breach of fiduciary duty was weak, the Court allowed the claim to be presented to a jury.

In a decision in litigation by a corporate securities issuer alleging an underwriter's failure to disclose a conflict of interest in an initial public offering (IPO) of corporate stock when the underwriter allegedly had assumed an advisory role for the corporate issuer, the New York Court of Appeals granted the underwriter's motion to dismiss a number of contractual and other claims on behalf of the issuer against the underwriter. The Court nevertheless affirmed decisions of the lower courts denying a motion to dismiss a claim for breach of fiduciary duty against the underwriter.

In a lengthy discussion of the roles and responsibilities of underwriters, the Court of Appeals stated:

> A fiduciary relationship "exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation" (Restatement [Second] of Torts § 874, Comment a). Such a relationship, necessarily fact-specific, is grounded in a higher level of trust than normally present in the marketplace between those involved in arm's length business transactions … . Generally, where parties have entered into a contract, courts look to that agreement "to discover … the nexus of [the parties'] relationship and the particular contractual expression establishing the parties' interdependency" … . "If the parties … do not create their own relationship of higher trust, courts should not ordinarily transport them to the higher realm of relationship and fashion the stricter duty for them" … . However, *it is fundamental that fiduciary "liability is not dependent solely upon an agreement or contractual relation between the fiduciary and the beneficiary but results from the relation"* (Restatement [Second] of Torts § 874, Comment b).
>
> Goldman Sachs argues that the relationship between an issuer and underwriter is an arm's length commercial relation from which fiduciary duties may not arise. It may well be true that the underwriting contract, in which Goldman Sachs agreed to buy shares and resell them, did not in itself create any fiduciary duty. However, *a cause of action for breach of fiduciary duty may survive, for pleading purposes, where the complaining*

> *party sets forth allegations that, apart from the terms of the contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone.*
>
> Here, the complaint alleges an advisory relationship that was independent of the underwriting agreement. *Specifically, plaintiff alleges eToys was induced to and did repose confidence in Goldman Sachs' knowledge and expertise to advise it as to a fair IPO price and engage in honest dealings with eToys' best interest in mind*. Essentially, according to the complaint, eToys hired Goldman Sachs to give it advice for the benefit of the company, and Goldman Sachs thereby had a fiduciary obligation to disclose any conflict of interest concerning the pricing of the IPO. Goldman Sachs breached this duty by allegedly concealing from eToys its divided loyalty arising from its profit-sharing arrangements with clients.
>
> Contrary to Goldman Sachs' contention, recognition of a fiduciary duty to this limited extent—requiring disclosure of Goldman Sachs' compensation arrangements with its customers—is not in conflict with an underwriter's general duty to investors under the Securities Act of 1933 to exercise due diligence in the preparation of a registration statement. An obligation not to conceal from the issuer private arrangements made with a group of potential investors does not compromise Goldman Sachs' charge to be truthful in its public disclosure regarding the issuer's business. For similar reasons, we do not share the dissent's concern that upholding an issuer's fiduciary duty claim against an underwriter "potentially conflicts with a highly complex regulatory framework designed to safeguard investors" … . Recognizing a common-law remedy, under these circumstances, will not hinder the efforts being expended to regulate in this area.
>
> Goldman Sachs' additional argument that there could be no fiduciary duty in this case because eToys and Goldman Sachs functioned as a typical seller and buyer is also unavailing. Generally, a buyer purchases a seller's goods at a wholesale price and attempts to resell those goods at the highest possible profit. Such a transaction would negate any fiduciary duty concerning pricing advice as no rational seller would place trust in a buyer's pricing given the parties' opposing interests. Here, in contrast, Goldman Sachs and eToys allegedly agreed to a fixed profit from the selling of the securities—Goldman Sachs was to receive about 7% of the offering proceeds. Thus eToys allegedly believed its interests and those of Goldman Sachs were aligned: the higher the price, the higher Goldman Sachs' 7% profit. Consequently, eToys allegedly had a further reason to trust that Goldman Sachs would act in eToys' interest when advising eToys on the IPO price.

> Goldman Sachs warns that to find a fiduciary relationship in this case may have a significant impact on the underwriting industry. We think its concern is overstated. *To the extent that underwriters function, among other things, as expert advisors to their clients on market decisions, a fiduciary duty may exist.* We stress, however, that the fiduciary duty we recognize is limited to the underwriter's role as advisor. We do not suggest that underwriters are fiduciaries when they are engaged in activities other than rendering expert advice. *When they do render such advice, the requirement to disclose any material conflicts of interest that render the advice suspect should not burden them unduly*.
>
> Accepting the complaint's allegations as true, as the Court must at this stage, plaintiff has sufficiently stated a claim for breach of fiduciary duty. This holding is not at odds with the general rule that fiduciary obligations do not exist between commercial parties operating at arms'-length—even sophisticated counseled parties—and we intend no damage to that principle. Under the complaint here, however, the parties are alleged to have created their own relationship of higher trust beyond that which arises from the underwriting agreement alone, which required Goldman Sachs to deal honestly with eToys and disclose its conflict of interest—the alleged profit-sharing arrangement with prospective investors in the IPO.
>
> *EBC I, Inc. v. Goldman, Sachs & Co.*, 5 N.Y.3d 11, 19-22, 832 N.E.2d 26, 31-33, 799 N.Y.S.2d 170, 175-77 (NY 2005). [Emphasis added; citations and footnotes omitted.]

Another New York court expressed similar views as to relationships between an investment bank and an issuer, stating—

> As a general matter, an arms-length lender-borrower or creditor-debtor contractual relationship may not give rise to a fiduciary obligation on the part of the lender or creditor … . Nor is the mere communication of confidential information sufficient in of itself to create a fiduciary relationship between a bank and its customers. At the same time, however, *it is not mandatory that a fiduciary relationship be formalized in writing*, and any inquiry into whether such obligation exists is necessarily fact-specific to the particular case. Beyond what may be memorialized in writing, *a court will look to whether a party reposed confidence in another and reasonably relied on the other's superior expertise or knowledge* … . Thus, the ongoing conduct between parties may give rise to a fiduciary relationship that will be recognized by the courts … . This is precisely what plaintiffs alleged occurred here.
>
> *Weiner v. Lazard Freres & Co.*, 241 A.D.2^{d} 114, 672 N.Y.S.2^{d} 8, 14 (NY Sup. Ct., App. Div., 1st Dept. 1998). [Emphasis added.]

Yet another New York Court added to the EBC I decision, enumerating not only an advisory relationship as a basis for a fiduciary duty, but also another basis in the form of a pre-existing relationship, as follows—

> [T]here is no indication or suggestion that Morgan and WellCare enjoyed any type of pre-existing relationship, or that Morgan acted as an "expert advisor on market conditions" to WellCare in the same way that Goldman Sachs apparently advised eToys.
>
> *HF Management Services LLC v. Pistone*, 34 A.D.3d 82, 818 N.Y.S.2d 40 (NY App. Div., 1st dept. 2006).

In other actions, courts have held that investment banking firms acting in principal capacities may have fiduciary duties to clients. See also, *e.g*., *SEC v. Rauscher Pierce Refsnes, Inc., James R. Feltham and Dain Rauscher Inc*., 17 F.Supp.2d 985 (D. AZ 1998) (a dealer that served as financial advisor to an issuer and sold securities to the issuer as principal); *In re Daisy Systems Corp*., 97 F.3d 1171, 1178-79 (9th Cir. 1996) (investment banking firm provided advice regarding an acquisition).

The bottom line is that an underwriter's provision of advice within a relationship of trust and confidence between the underwriter, on one hand, and a municipal entity or obligated person, on the other, outside typical underwriting roles involving principals dealing *solely* at arms'-length should give rise to municipal advisor status. The relationship of trust and confidence may arise from the outset of the relationship, or may arise later, and may arise in facts and circumstances based upon representations made by the underwriter to the municipal entity or obligated person, or upon the underwriter's conduct, or both.

If, however, a dealer functioning as an underwriter has explained explicitly in writing at the outset of the relationship to a municipal entity's or obligated person's policy makers that the underwriter is not undertaking to provide advice as a fiduciary, and that advice provided by the underwriter is not proffered with the intent to place the municipal entity's or obligated person's interests first or in the best interests of the municipal entity or obligated person, then (assuming that the underwriter does not make contradictory representations or engage in contradictory conduct) the facts and circumstances would mitigate against existence of a relationship of trust and confidence and the underwriter may be viewed fairly as falling within the narrow 1933 Act exception to the municipal advisor definition for underwriters.

Conclusion

When dealers serving issuers as underwriters step beyond the typical arms'-length underwriting role of marketing the issuers' securities to investors, the underwriters can and do create facts and circumstances in which it is appropriate under the Dodd-Frank Act to recognize that the dealers also serve as municipal advisors and are subject to the fiduciary duty of municipal advisors to municipal entities and obligated persons, as well as the special antifraud provision, professional standards, and other aspects of municipal advisor regulation.

Such facts and circumstances include the existence of relationships of trust and confidence of dealers with municipal entities or obligated persons in which the dealers **(1)** provide advice while serving as agents, within the scope of the agency relationships; **(2)** provide advice regarding cash flows or other projections of revenues or expenses (as distinguished from debt service calculations based upon stated assumptions, as relevant to structure and terms of securities) or regarding feasibility of projects or programs; **(3)** provide assistance or advice in negotiating key agreements, especially credit agreements with third parties upon which municipal entities or obligated persons rely in conjunction with municipal securities issues; or **(4)** provide advice and induce reliance by municipal entities or obligated persons upon that advice without informing the municipal entities' or obligated persons' policy makers that the dealers are not proffering the advice in fiduciary capacities placing the interests of the municipal entities' or obligated persons' interests first or as to the municipal entities' or obligated persons' best interests.

In addition to recognizing other facts and circumstances in which dealers step beyond typical underwriting roles, I suggest respectfully that the Commission recognize the critical importance of acknowledging these additional facts and circumstances to sound practices in the municipal securities market and to encourage municipal entities and obligated persons to seek appropriate professional advice that protects both the entities and persons, on one hand, and investors, on the other.