MSRB
Municipal Securities Rulemaking Board

December 16, 2015

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-MSRB-2015-03 - Response to Comments

Dear Secretary:

On April 24, 2015, the Municipal Securities Rulemaking Board ("MSRB" or the "Board") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change consisting of proposed new MSRB Rule G-42, on duties of non-solicitor municipal advisors ("Proposed Rule G-42" or "Proposed Rule") and related proposed amendments to MSRB Rule G-8, on books and records to be made by brokers, dealers, municipal securities dealers, and municipal advisors.[1] The SEC received fifteen comment letters in response to the notice. On August 6, 2015, the SEC issued an order instituting proceedings to determine whether to approve or disapprove the proposed rule change ("OIP").[2] On August 12, 2015, the MSRB submitted a letter to the SEC responding to the comments regarding the proposed rule change ("MSRB Response") [3] and filed with the SEC partial Amendment No. 1 to SR-MSRB-2015-03 ("Amendment No. 1").[4] In response to the OIP or Amendment No. 1, the SEC received thirteen additional comment letters.[5]

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1 See Exchange Act Release No. 74860 (May 4, 2015), 80 FR 26752 (May 8, 2015) (notice of proposed rule change SR-MSRB-2015-03 and request for comment) ("Notice of Proposed Rule G-42").

2 The OIP was published for notice and comment on August 12, 2015. See Exchange Act Release No. 75628 (August 6, 2015), 80 FR 48355 (August 12, 2015).

3 See letter to Secretary, SEC, from Michael L. Post, General Counsel – Regulatory Affairs, Response to Comments on SR-MSRB-2015-03, dated August 12, 2015, available at: http://www.sec.gov/comments/sr-msrb-2015-03/msrb201503.shtml.

4 Amendment No. 1 was published for notice and comment on August 25, 2015. See Exchange Act Release No. 75737 (August 19, 2015), 80 FR 51645 (August 25, 2015) ("Amendment No. 1 Notice").

5 See letters from Michael Nicholas, Chief Executive Officer, Bond Dealers of America ("BDA"), dated September 11, 2015 and November 4, 2015; John C. Melton, Sr., Executive Vice President, Coastal Securities ("Coastal Securities"), dated September 11, 2015; Jeff White, Principal, Columbia Capital Management, LLC ("Columbia Capital"),

On November 9, 2015, in response to comment letters received in response to the OIP or Amendment No. 1, the MSRB filed partial Amendment No. 2 to SR-MSRB-2015-03 ("Amendment No. 2").[6] In Amendment No. 2, the MSRB stated that it would respond to the comments received by the SEC in response to the OIP or Amendment No. 1 together with its response to the comments received by the SEC in response to Amendment No. 2, if any. The SEC received six comment letters in response to Amendment No. 2.[7]

Throughout the development of draft Rule G-42, and subsequently Proposed Rule G-42, the MSRB has sought public comment regarding the rule to understand, address and balance the concerns of municipal entities and obligated persons, their municipal advisors, broker-dealers and other financial service providers, investors (both institutional and retail), and the public, including the constituents of municipal entities, with the mandate to establish a regulatory framework for municipal advisors. As Rule G-42 was crafted, the MSRB carefully considered each set of comments, as reflected in revisions to the rule text that were responsive to or derivative of the comments in the MSRB's Second Request for Comment,[8] the Notice of

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dated September 10, 2015; Joshua Cooperman, Cooperman Associates ("Cooperman"), dated September 9, 2015; David T. Bellaire, Executive Vice President & General Counsel, Financial Services Institute ("FSI"), dated September 11, 2015; Dustin McDonald, Director, Federal Liaison Center, Government Finance Officers Association ("GFOA"), dated September 14, 2015; Tamara K. Salmon, Associate General Counsel, Investment Company Institute ("ICI"), dated September 11, 2015; Lindsey K. Bell, Millar Jiles, LLP ("Millar Jiles"), dated September 11, 2015; Terri Heaton, President, National Association of Municipal Advisors ("NAMA"), dated September 11, 2015; Leslie M. Norwood, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association ("SIFMA"), dated September 11, 2015; Joy A. Howard, Principal, WM Financial Strategies ("WM Financial"), dated September 11, 2015; and W. David Hemingway, Executive Vice President, Zions First National Bank ("Zions"), dated September 10, 2015.

6 Amendment No. 2 was published for notice and comment on November 17, 2015. See Exchange Act Release No. 76420 (November 10, 2015), 80 FR 71858 (November 17, 2015) ("Amendment No. 2 Notice").

7 See letters from Michael Nicholas, Chief Executive Officer, BDA, dated December 1, 2015; David T. Bellaire, Executive Vice President and General Counsel, FSI, dated December 1, 2015; Dustin McDonald, Director, Federal Liaison Center, GFOA, dated December 1, 2015; Tamara K. Salmon, Associate General Counsel, ICI, dated December 1, 2015; Terri Heaton, President, NAMA, dated December 7, 2015; Leslie M. Norwood, Managing Director and Associate General Counsel, SIFMA, dated December 1, 2015.

8 See MSRB Notice 2014-12 (July 23, 2014) ("Second Request for Comment").

Proposed Rule Change G-42, Amendment No. 1 and Amendment No. 2. The MSRB also provided detailed explanations of the revisions and decisions not to revise in the Second Request for Comment, the Notice of Proposed Rule G-42, Amendment No. 1, the MSRB Response and Amendment No. 2. Many commenters expressed their appreciation that the MSRB had been responsive to their previous comments and concerns, based upon the MSRB's revisions of the rule in each of its iterations. In response to comments during this process, virtually all of the issues addressed in the rule have been re-considered and related text revised, including, but not limited to the provision regarding, and guidance related to, a municipal advisor's duty of loyalty and duty of care, requirements regarding the disclosure of conflicts and the documentation of the relationship, procedures to address a municipal advisor inadvertently engaging in municipal advisory activities, issues regarding recommendations and suitability, and conduct specifically prohibited, including the prohibition on principal transactions. Some commenters, however, expressed some continuing or additional concerns during the development of Rule G-42, which the MSRB has continued to consider and address. The request for comment on Amendment No. 2 was the sixth solicitation of comments during this rulemaking initiative.[9] Some commenters have raised the same or similar issues in response to Amendment No. 1 or the OIP, and in the most recent submission of comments in response to Amendment No. 2, that they raised previously. Each of the issues and concerns raised in the comments has been thoroughly reviewed and considered, and for those comments that were raised previously, carefully re-considered.

This letter responds to the comments received by the SEC in response to the OIP, Amendment No. 1 and Amendment No. 2. The letter has two main sections, the first addressing comments related to the principal transaction ban and an exception to the ban based on disclosure and client consent, and the second addressing comments on all other matters.

I. PRINCIPAL TRANSACTION BAN AND EXCEPTION

Principal Transaction Ban

In response to Amendment No. 1 or the OIP, BDA, Coastal Securities, FSI, GFOA, Millar Jiles, SIFMA and Zions commented on Proposed Rule G-42(e)(ii) regarding the proposed prohibition on certain principal transactions ("principal transaction ban" or "ban").[10] The

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9 In addition to the opportunity to comment in response to the Notice of Proposed Rule G-42, the MSRB twice solicited comments on draft versions of Proposed Rule G-42. See MSRB Notice 2014-01 (January 9, 2014) ("First Request for Comment") and Second Request for Comment.

10 Proposed Rule G-42(e)(ii), as amended by Amendment No. 1, provided:

> A municipal advisor to a municipal entity client, and any affiliate of such municipal advisor, is prohibited from engaging with the municipal entity

commenters generally expressed concerns about the breadth of the ban and the lack of any exception. Five of these commenters—BDA, FSI, Millar Jiles, SIFMA and Zions—commented that, if no exception to the proposed principal transaction ban were added, the Proposed Rule would be inconsistent with one or more of the following provisions of the Securities Exchange Act of 1934 ("Exchange Act"):[11] Section 15B(b)(2)(L),[12] Section 15B(b)(2)(L)(i),[13] Section

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> client in a principal transaction that is the same, or directly related to the, municipal securities transaction or municipal financial product as to which the municipal advisor is providing or has provided advice to the municipal entity client.

Proposed Rule G-42(e)(ii), as amended by Amendment No. 2, provides:

> Except as provided for in paragraph .14 of the Supplementary Material of this rule, a municipal advisor to a municipal entity client, and any affiliate of such municipal advisor, is prohibited from engaging with the municipal entity client in a principal transaction that is the same, or directly related to the, issue of municipal securities or municipal financial product as to which the municipal advisor is providing or has provided advice to the municipal entity client.

[11] See letters from BDA, dated September 11, 2015; FSI, dated September 11, 2015; Millar Jiles, dated September 11, 2015; SIFMA, dated September 11, 2015; and Zions, dated September 10, 2015; raising concerns regarding the following provisions of the Exchange Act, in connection with the principal transaction ban: Section 15B(b)(2)(L) (SIFMA and Zions); Section 15B(b)(2)(L)(i) (BDA, FSI, SIFMA and Zions); Section 15B(b)(2)(C) (FSI, SFIMA and Zions); and Section 3(f) (Millar Jiles and SIFMA).

[12] Section 15B(b)(2)(L) of the Exchange Act provides that, with respect to municipal advisors, the rules of the MSRB, as a minimum shall:

> (i) 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; (ii) provide continuing education requirements for municipal advisors; (iii) provide professional standards; and (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.

15 U.S.C. 78o-4(b)(2)(L).

[13] 15 U.S.C. 78o-4(b)(2)(L)(i).

15B(b)(2)(C),[14] and Section 3(f).[15] The commenters suggested exceptions to the proposed ban or other changes, including an exception modeled on those found in other regulatory regimes, an exception when advice is provided to a municipal entity client that is incidental to securities execution services, an exception limited to riskless principal transactions in certain fixed income securities, an exception when the municipal entity is otherwise represented with respect to the principal transaction by another registered municipal advisor, an exception for affiliates or remote businesses, and modifications to narrow the scope of the prohibition.

Prior to the comments in response to Amendment No. 1 or the OIP, the MSRB concluded that the principal transaction ban should be retained with the breadth as proposed. [16] After carefully considering the comments in response to Amendment No. 1 and the OIP, however, including those of GFOA, generally, representative of a key class of entities that Proposed Rule G-42 is intended to protect, the MSRB determined to incorporate an exception in Proposed Rule G-42 ("Exception"). As discussed below and in Amendment No. 2, the MSRB believes that the Exception will address the primary concerns expressed by commenters regarding the ban.

Comparison to Other Regulatory Regimes

In response to Amendment No. 1 or the OIP, BDA, Coastal Securities, FSI, Millar Jiles, SIFMA and Zions commented that the Proposed Rule's principal transaction ban should be revised to permit municipal advisors to engage in principal transactions with their municipal entity clients, provided that disclosure of conflicts is made to the client and the client consents.[17]

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14 15 U.S.C. 78o-4(b)(2)(C).

15 Section 3(f) of the Exchange Act provides, in pertinent part, that when the Commission is engaged in

> the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

15 U.S.C. 78c(f).

16 See Notice of Proposed Rule G-42, 80 FR at 26773-83 (discussing comments letters filed in response to the First Request for Comment and the Second Request for Comment regarding prior versions of the proposed ban on principal transactions).

17 See letters from BDA, dated September 11, 2015; Coastal Securities, dated September 11, 2015; FSI, dated September 11, 2015; Millar Jiles, dated September 11, 2015; SIFMA, dated September 11, 2015; and Zions, dated September 10, 2015.

BDA and SIFMA commented generally that the proposed ban is more restrictive and inflexible regarding the duty of loyalty and fiduciary obligations than the approach in other financial regulatory regimes.

Commenters suggested that the MSRB consider incorporating an exception to the proposed ban modeled on, or similar to, Section 206(3) of the Investment Advisers Act of 1940 ("Advisers Act")[18] or Advisers Act Rule 206(3)-3(T), [19] available to firms dually registered as a broker-dealer and investment adviser.[20] BDA contrasted the MSRB's approach under Proposed Rule G-42 to other regulatory schemes, citing as examples, the "conflict management process" relating to the execution of principal transactions by fiduciaries (i.e., as provided in Section 206(3) for investment advisers,[21] and in the IA Rule, for investment advisers that are dually registered as broker-dealers).[22] FSI commented that the IA Rule "illustrates that authorizing principal trades in certain circumstances is consistent with a fiduciary duty" and that "the reasoning behind the [Advisers Act Rule] . . . should also apply to dually registered municipal advisors."[23] FSI and Millar Jiles stated that a ban on principal transactions was unnecessary in view of the fiduciary relationship between a municipal advisor and its municipal entity client. Millar Jiles also commented that, when interpreting Section 206(3), the SEC had stated that Congress recognized the potential for self-dealing by investment advisers, but did not prohibit advisers from engaging in all principal and agency transactions with clients, instead addressing the particular conflicts of interest with disclosure and client consent.[24] Millar Jiles suggested that the MSRB could act consistently with the overall intent of Proposed Rule G-42 by adopting the disclosure and consent approach set forth in the Advisers Act, and commented that the MSRB previously indicated that it had drawn from the Advisers Act and Form ADV[25] in developing other aspects of Proposed Rule G-42 (e.g., certain definitions and conflicts of interest

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18 15 U.S.C. 80b-6(3) ("Section 206(3)").

19 17 CFR 275.206(3)-3T ("IA Rule").

20 See, e.g., letters from BDA, dated September 11, 2015; FSI, dated September 11, 2015; Millar Jiles, dated September 11, 2015; SIFMA, dated September 11, 2015; and Zions, dated September 10, 2015 (referring to the IA Rule).

21 15 U.S.C. 80b-6(3).

22 17 CFR 275.206(3)-3T.

23 See FSI letter, dated September 11, 2015.

24 See Millar Jiles letter, dated September 11, 2015 (referring to SEC Interpretation of Section 206(3) of the Advisers Act, Release No. IA-1732 (July 17, 1998)).

25 17 CFR 279.1.

disclosures). Zions commented that the proposed ban is inconsistent with the federal regulation of investment advisers, and stated that the MSRB has no basis for treating municipal advisors differently than investment advisers when setting fiduciary duty standards, and municipal advisors should be permitted to engage in principal transactions with their municipal entity clients, provided that advice and consent requirements are met.

Advice Incidental to Securities Execution Services

In response to Amendment No. 1 or the OIP, BDA, FSI, GFOA, and SIFMA also suggested that the MSRB consider an exception to the ban for limited advice that is incidental to securities execution services.[26] SIFMA contrasted a municipal advisor to a municipal entity advising on a large issuance of municipal securities with a municipal advisor that is also a broker-dealer providing "brokerage with sporadic incidental advice on the investment of the proceeds of a previous issuance," commenting that "the scope, extent, risks, formalities, and conflicts present in these relationships differ fundamentally."[27] GFOA acknowledged that the ban makes sense in the context of a traditional financial advisor. GFOA expressed a concern, however, regarding what it viewed to be a removal of the issuer from the conflicts of interest process and the lack of an exception to the proposed ban regarding the investment of proceeds of municipal securities and municipal escrow investments. GFOA further expressed concern that the ban "could force small governments to open a more expensive fee-based arrangement with an investment advisor in order to receive this very limited type of advice on investments that are not risky."[28] FSI stated that a ban on transactions, where the advice is incidental to the securities execution services, would impose an unnecessary burden on competition, and suggested an exception be incorporated for transactions executed in such circumstances. FSI also suggested that the exception could be limited to transactions in certain fixed income securities or, alternatively, limited to riskless principal transactions in certain fixed income securities.[29] Commenters, including BDA, FSI, GFOA, Millar Jiles, SIFMA and Zions, noted the importance, in their view, of: (i) preserving municipal entities' choice and access to services and products at

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26 See letters from BDA, dated November 4, 2015; FSI, dated September 11, 2015; GFOA, dated September 14, 2015; and SIFMA, dated September 11, 2015. See also MSRB Response at 12-14; see also Notice of Proposed Rule G-42, 80 FR at 26780-81.

27 See SIFMA letter, dated September 11, 2015.

28 See GFOA letter, dated June 15, 2015.

29 See FSI letters, dated May 29, 2015 and September 11, 2015.

favorable prices; (ii) preserving municipal entities' access to financial advisors with whom such municipal entities have relationships; and (iii) avoiding increased costs to municipal entities.[30]

The issues and concerns raised by commenters as set forth above in "Comparison to Other Regulatory Regimes" and "Advice Incidental to Securities Execution Services" are addressed principally by the MSRB's incorporation of an exception to the principal transaction ban, and are addressed more fully in the MSRB's discussion below of the exception in "The Exception to the Principal Transaction Ban."

Other Comments Regarding the Principal Transaction Ban

"Separate Registered Municipal Advisor" Exception

In response to Amendment No. 1 or the OIP, SIFMA commented that an exception should be added to Proposed Rule G-42(e)(ii) to permit an otherwise prohibited principal transaction "where the municipal entity is otherwise represented with respect to the principal transaction by another separate registered municipal advisor (an "SRMA")."[31] SIFMA commented that a SRMA exception would be analogous to SEC Rule 15Ba1-1(d)(3)(vi), [32] under which a person engaging in municipal advisory activities is exempt from the municipal advisor definition where the municipal entity client (or an obligated person client) is otherwise represented by an independent registered municipal advisor ("IRMA") with respect to the same aspects of a municipal financial product or an issuance of municipal securities, provided specific additional requirements are met. In SIFMA's opinion, if the SRMA exception were adopted, a municipal entity would be protected from the risk of potential self-dealing where the municipal entity has engaged and would rely on the advice of the SRMA.

The MSRB has concluded that the incorporation at this stage of an exception to the ban like that suggested by SIFMA would be premature, add additional, and unnecessary, complexity and be potentially burdensome to administer. To provide appropriate protection to municipal entities while including an exception such as that suggested by SIFMA, it likely would be necessary to impose a number of conditions, as the MSRB previously noted.[33] At this time, the MSRB believes that the Exception to the proposed ban is the more appropriate approach to

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30 See letters from BDA, dated September 11, 2015 and November 4, 2015; FSI, dated September 11, 2015; GFOA, dated September 14, 2015; Millar Jiles, dated September 11, 2015; SIFMA, dated September 11, 2015; and Zions, dated September 10, 2015.

31 See SIFMA letter, dated September 11, 2015.

32 17 CFR 240.15Ba1-1(d)(3)(vi).

33 See MSRB Response at 21-22 (identifying some of the substantial additional relationship documentation that likely would be required).

maintain the necessary protections for municipal entities, investors and the public while helping to ensure that issuers will continue to have access to a competitive market for municipal advisory and other financial services. The MSRB believes the Exception will provide a useful, practical path for a municipal advisor that is otherwise prohibited from engaging in certain principal transactions with its municipal entity client to do so, subject to the stated terms and conditions, and the MSRB has proposed the Exception to be responsive to the comments from a range of commenters, including SIFMA.

Affiliates

In response to Amendment No. 1 or the OIP, SIFMA commented that the MSRB failed to consider limiting the application of the ban to affiliates of a municipal advisor that have no knowledge of the municipal advisory engagement, or more broadly to affiliates and business units of the municipal advisor that have no such knowledge.[34] SIFMA noted that it disagreed with the MSRB's position on this matter because, as SIFMA's letter recounts, Congress and other financial regulators have enacted legislation and rules that "adopt exclusions from substantive requirements for business units of regulated entities or their affiliates that are not involved in, or structurally isolated from, regulated activity."[35] SIFMA commented that the Proposed Rule would "significantly harm competition" because it would lead to municipal advisor firms exiting the municipal advisory marketplace. SIFMA further commented that many multiservice firms, such as municipal advisors affiliated with dealers, will determine that the principal transaction ban would make the provision of municipal advisory services too costly to be worth offering. Finally, SIFMA commented that a decrease in municipal advisors may result in the remaining firms increasing their fees and a deterioration in the quality of the services provided by municipal advisory firms.

After carefully considering the comments, the MSRB continues to believe that the proposed principal transaction ban, as to affiliates, is appropriately targeted, given the acute nature of the conflicts of interest presented and the risk of self-dealing by affiliates in transactions that are "directly related" to the municipal securities transaction or municipal financial product as to which the affiliated municipal advisor has provided advice. Moreover, if the prohibition on principal transactions as it applies to affiliates were modified by the term "knowingly" as suggested, the MSRB believes that the standard would be overly stringent, which could hinder regulatory examinations and enforcement. The MSRB believes that the concerns expressed by various commenters, including the concerns regarding the potential impact on competition in the municipal advisory marketplace, will be substantially mitigated, if

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34 The MSRB responded to a prior comment by SIFMA regarding this matter, stating that SIFMA's suggestion to add a knowledge qualifier would be overly stringent, which could hinder regulatory examinations and enforcement. See MSRB Response at 16.

35 See SIFMA letter, dated September 11, 2015.

they at all manifest, by the MSRB's inclusion of the Exception to the principal transaction ban, described in detail below.

Governing Body Approval

In response to Amendment No. 1 or the OIP, BDA commented that it appreciates the MSRB's effort "to formulate a conflicts of interest regime that mitigates the risks to issuers and the marketplace associated with the potential for self-dealing,"[36] and recognized that self-dealing transactions can raise serious concerns for issuers. BDA also commented that potential abuses should be principally addressed through the design of a framework and a rigorous, transparent and accountable process and not through an outright ban. More specifically, BDA suggested that the principal transaction ban be amended not only for municipal advisors providing advice in connection with the trading as principal of securities, but also to allow most principal transactions if the transaction is approved by the governing body of the municipal entity client after the governing body has been fully informed about any actual or potential conflicts of interest associated with the principal transaction.[37] BDA suggested that "governing body" of a municipal entity be defined to mean "the elected or appointed legislative body of a municipal entity, or the board of the municipal entity responsible for the governance of the municipal entity."[38] BDA further suggested that, with respect to states or territories, the term would mean "the elected or appointed constitutional officer or department or agency authorized to issue bonds on behalf of the municipal entity."[39]

After carefully considering the comments, the MSRB concluded that the exception proposed by BDA, which is quite broadly drawn, may, in many instances, not address the type of self-dealing transactions and the resulting abuses from self-dealing that the statutory requirements and the developing regulatory framework for municipal advisors were intended to address. For example, currently, under most state and local law, expenditures of substantial public funds must be approved by the governing body, or, for lesser expenditures, by a person exercising power delegated by the governing body. Thus, the exception suggested by the BDA may reflect in many places, restrictions currently in place, but which historically have not proven effective in preventing abuse. Also, certain municipal entities, including states, may experience significant difficulties in the identification of, and application of the procedural requirements in connection with, the appropriate "governing body." Even if both conditions (i.e., disclosure of potential and actual conflicts of interest and a vote approving the transaction) were incorporated in an exception of the scope suggested by BDA, the MSRB believes that the conflicts of interest

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36 See BDA letter, dated November 4, 2015.

37 See id.

38 See id.

39 See id.

of the municipal entity's counter-party—its own municipal advisor—would be fully present, and not sufficiently mitigated to eliminate or substantially reduce the concerns of overreaching and self-dealing and other actions inconsistent with the fiduciary duty of the municipal advisor. However, the MSRB believes that the Exception, discussed below, is responsive to the concerns raised by the BDA generally. The Exception is based on an appropriate process requiring full disclosure by the municipal advisor and consent by the municipal entity. For these reasons, the MSRB declines to adopt the suggested exception at this time.

Directly Related To

In response to Amendment No. 1 or the OIP, SIFMA commented that the MSRB failed to consider a suggestion to amend the ban to limit its scope to principal transactions that are directly related to the advice provided by the municipal advisor.[40]

The MSRB considered this comment, and previously reviewed and considered several comments regarding the scope of the principal transaction ban, including similar prior comments from SIFMA.[41] After carefully reconsidering the comment, the MSRB has determined not to narrow, broaden or otherwise modify the standard in this regard. The MSRB believes that the alternative rule text suggested by SIFMA would not be a more effective or efficient means for achieving the stated objective of the proposed ban, which is to eliminate a category of particularly acute conflicts of interest that would arise in a fiduciary relationship between a municipal advisor and its municipal entity client. In its previous discussion, the MSRB noted that the suggested 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 of municipal securities arguably would not be prohibited from acting as principal in entering into an interest rate swap for the same issuance so long as the municipal advisor refrained from advising on the swap. Moreover, the MSRB has modified the proposed ban to incorporate the Exception, discussed below. Particularly in light of the MSRB's incorporation of the Exception, the MSRB does not believe it is appropriate to further modify the ban at this time.

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40 See SIFMA letter, dated September 11, 2015.

41 See MSRB Response at 15. See also letters from BDA, dated August 25, 2014; SIFMA, dated August 25, 2014, submitted in response to the Second Request for Comment. See also Notice of Proposed Rule G-42, 80 FR at 26779 n.73, 26780 (MSRB discussed comments suggesting that the MSRB amend the "directly related to" standard, and concluded that the standard should not be changed).

Banking Law

In response to Amendment No. 1 or the OIP, Zions commented that the principal transaction ban is overly broad and inconsistent with federal banking laws, and, as an alternative to generally permitting principal transactions (subject to disclosure and consent requirements), bank loans should be excluded in their entirety from the ban.[42] Zions commented that banks, as highly regulated entities, should be allowed to continue offering traditional banking services to municipal entities, including as principal. Zions further commented that determining on a case-by-case basis whether a particular transaction is economically equivalent to the purchase of one or more municipal securities is unnecessarily complex and costly for products that are already thoroughly regulated. As an example of the complexity of applying the standard, Zions stated that the written evidence of indebtedness from municipal entities must have virtually the same structure and provisions that would be in place for a municipal security. Zions stated that the only clear way to distinguish between direct bank loans and municipal securities is to look at the intent of the acquirer at the time of acquisition. In Zions's view, if the indebtedness is acquired with an intent to distribute, the instrument should be deemed a security, but if a bank acquires the indebtedness directly for its own portfolio with no intent to distribute, the instrument is, and should be treated as, a bank loan.

If bank loans are potentially subject to the ban, Zions suggested, as an alternative, that the threshold bank loan amount be higher than $1 million. Zions believed that the threshold amount should be consistent with, and pegged to, the $10 million threshold for bank-qualified obligations under Section 265 of the Internal Revenue Code.[43] In addition, Zions commented that, for the Proposed Rule to be consistent with the Exchange Act, the proposed threshold should be raised to $10 million. Zions also commented that unless the threshold amount were increased the proposed ban would be inconsistent with the goals of the Community Reinvestment Act ("CRA").[44] Zions believed that the ban may prevent municipal advisors, such as Zions, from issuing direct loans to smaller and more remote municipal entities and/or cause banks to provide services to underserviced municipalities in less than all three of the required categories of the CRA (i.e., lending, investments and financial services).[45]

The MSRB previously received several comments, including a comment from Zions that banks, as highly regulated entities, should be allowed to continue to offer traditional banking services to municipal entities, including bank loans and other principal transactions, and stating

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42 See Zions letter, dated September 10, 2015.

43 26 U.S.C. 265 et seq.

44 12 U.S.C. 2901 et seq.

45 See id.

their concerns regarding the proposed provision in the Supplementary Material ("SM") under which a bank loan would be an "other similar financial product" for purposes of the principal transaction ban, if the loan were "in an aggregate principal amount of $1,000,000 or more" and "economically equivalent to the purchase of one or more municipal securities." The MSRB notes that Zions's concerns are addressed to some extent by the bank exemption from the definition of "municipal advisor." Under Exchange Act Rule 15Ba1-1(d)(3)(iii),[46] a bank is exempt from the definition of municipal advisor to the extent that the bank engages in specified activities, which include many traditional banking activities, including providing advice with respect to any investment held in a deposit or savings account, a certificate of deposit, or other deposit instrument issued by a bank; providing advice regarding any extension of credit by a bank to a municipal entity, 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; and providing advice regarding funds held in certain sweep accounts or regarding any investment made by the bank as an indenture trustee or in a similar capacity. Even in situations where a bank's provision of advice were not exempt and Proposed Rule G-42 and the ban applied, Zions's concerns referenced above and its concern regarding the impact to smaller communities or projects in such communities as a result of the proposed ban, should be substantially ameliorated because the MSRB has added the Exception. In addition, the MSRB previously stated and continues to believe, in response to comments suggesting that bank loans be excluded from the principal transaction ban, that the group of bank loans that may be subject to the proposed ban would be substantially limited. The group would include only those bank loans that would be the same as, or directly related to, the issue of municipal securities or municipal financial product as to which the bank municipal advisor is providing or has provided advice and that would be considered "economically equivalent to the purchase of one or more municipal securities."[47] Moreover, in general, bank loans were included in the ban and should remain as a "similar financial product" because, as a matter of market practice, bank loans 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. In addition, the MSRB does not find support in the comments for importing into the proposed term, "Other Similar Financial Products," an unrelated dollar threshold (i.e., $10 million) from a statutory provision regarding the bank qualification of municipal securities, in lieu of the proposed $1 million threshold. The MSRB previously noted that, after the MSRB has experience with the rule as in effect, the MSRB may consider whether the proposed threshold of $1 million should be modified.[48]

In response to Zions's comments that the principal transaction ban should be eliminated because of its possible impact on the CRA, the MSRB notes, as it has stated previously, that the

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46 17 CFR 240.15Ba1-1(d)(e)(iii).

47 See MSRB Response at 19.

48 See id.

proposed prohibition on principal transactions is narrowly targeted and would have a limited impact on a municipal advisor or its affiliate providing loans and financial services, generally. Further, Zions's comments do not demonstrate – and the MSRB is not aware of any indication – that Congress intended the requirements of the CRA to take precedence over other statutory and regulatory requirements, including those designed to address a category of transactions that pose a high risk of self-dealing.

The Exception to the Principal Transaction Ban

In Amendment No. 2, in response to multiple issues raised by commenters, the MSRB addressed a broad range of commenters' concerns by adding the Exception to the principal transaction ban in Proposed Rule G-42. The MSRB believes that the Exception will address the primary concerns expressed by commenters that, without an exception for transactions in certain fixed income securities when advice is given by the municipal advisor in connection with executing such transactions, the proposed ban would restrict the access of municipal entities to trusted financial advisors, limit their ability to obtain certain financial services and products, create undue burdens on competition and impose unjustified costs for issuers. The amendment of Proposed Rule G-42 to incorporate the Exception is in recognition that municipal advisors serve a diverse array of clients, and, in particular, municipal entity clients, which range from large state issuers to small school districts, special districts and other instrumentalities, public pension plans, and collective vehicles, such as local government investment pools ("LGIPs") and college savings plans that comply with Section 529 of the Internal Revenue Code,[49] and that municipal entity clients may have special needs of access to a range of services and particular types of financial products from municipal advisors and affiliated financial intermediaries. At the same time, the MSRB believes that the Proposed Rule, as amended, will further the protection of municipal entities, investors and the public interest.

The Exception is broader in scope than some of the exceptions suggested by the commenters, including the suggestion of several commenters that advice incidental to the execution of a securities transaction should not trigger the ban on principal transactions, and FSI's suggestion that an exception be limited to riskless principal transactions in certain fixed income securities when advice incidental to the transactions is given. Because the Exception is broader in scope, the MSRB believes that the Exception will address the concerns of FSI, GFOA and SIFMA, and provide municipal advisor/broker-dealers, and their municipal entity clients greater flexibility to engage in the type of principal transactions of most concern to the commenters as indicated in their comments.[50]

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49 26 U.S.C. 529.

50 See letters from FSI, dated September 11, 2015; GFOA, dated September 14, 2015; and SIFMA, dated September 11, 2015.

The Exception is incorporated as new proposed SM .14 to Proposed Rule G-42, and provides a municipal advisor two options by which it might engage in certain principal transactions with a municipal entity client, provided the municipal advisor also complies with the first three requirements set forth in SM .14 (organized as sections (a) through (c)). A municipal advisor would have the option to act, on a transaction-by-transaction basis, in accordance with a short set of procedural requirements, some of which are drawn from and similar to the requirements set forth in Section 206(3).[51] Alternatively, a municipal advisor that wishes to satisfy procedural requirements on other than a transaction-by-transaction basis would be subject to more and different procedural requirements, including obtaining from the municipal entity client a prospective blanket, written consent. These procedural requirements are drawn from and similar to those set forth in the IA Rule.[52]

Importantly, the Exception would operate only to take certain conduct out of the specified prohibition on certain principal transactions in Proposed Rule G-42(e)(ii). It would not provide a safe harbor from complying with any other applicable law or rules. Thus, a municipal advisor engaging in a principal transaction in compliance with the Exception would need to continue to be mindful of, and comply with, its broader and foundational obligations owed to the client as a fiduciary under the Exchange Act and Proposed Rule G-42, other MSRB rules, as well as all other applicable provisions of the federal securities laws and state law.[53]

All of the requirements for the Exception take the form of various conditions and limitations. Under proposed SM .14(a), a principal transaction could be excepted from the specified prohibition only if the municipal advisor also is a broker-dealer registered under Section 15 of the Exchange Act,[54] and each account for which the municipal advisor would be relying on the Exception is a brokerage account subject to the Exchange Act,[55] the rules thereunder, and the rules of the self-regulatory organizations(s) of which the broker-dealer is a member. In addition, the municipal advisor could not exercise investment discretion (as defined

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51 15 U.S.C. 80b-6(3).

52 17 CFR 275.206(3)-3T.

53 The MSRB's approach in this regard is consistent with that of the SEC with respect to principal transactions executed by investment advisers under Section 206(3) (15 U.S.C. 80b-6(3)) or the IA Rule.

54 15 U.S.C. 78o.

55 15 U.S.C. 78a et seq.

in Section 3(a)(35) of the Exchange Act)[56] with respect to the account, unless granted by the municipal entity client on a temporary or limited basis.[57]

Under proposed SM .14(b), neither the municipal advisor nor any affiliate of the municipal advisor may be providing, or have provided, advice to the municipal entity client as to an issue of municipal securities or a municipal financial product that is directly related to the principal transaction, except advice as to another principal transaction that also meets all the other requirements of proposed SM .14.[58]

Proposed SM .14(c) would limit a municipal advisor's principal transactions under the Exception to sales to or purchases from a municipal entity client of any U.S. Treasury security, agency debt security or corporate debt security. In addition, the Exception would not be available for transactions involving municipal escrow investments as defined in Exchange Act Rule 15Ba1-1(h)[59] because the MSRB believes that this is an area of heightened risk where, historically, significant abuses have occurred. The inclusion in the Exception of transactions in this class of fixed income securities is intended to address the concerns of commenters that an absolute ban on principal transactions in fixed income securities, which are frequently sold by broker-dealers as principal or riskless principal, would be particularly problematic, and also addresses comments that an exception limited to these generally relatively liquid securities trading in relatively transparent markets may raise significantly less risk for municipal entity clients.[60] The proposed class of securities may be broader than what would be permitted by

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56 15 U.S.C. 78c(a)(35).

57 The proposed requirements are similar to those found in Advisers Act Rule 206(3)-T(a)(7) and (1), respectively. 17 CFR 275.206(3)-3T(a)(7) and (1).

58 For example, a municipal advisor could not use the Exception to reinvest proceeds from an issue of municipal securities where it was a municipal advisor as to such issue. A municipal advisor could use the Exception, however, for two principal transactions with the same municipal entity client where the transactions are directly related to one another, so long as all of the conditions and limitations of the Exception are met as to each transaction.

59 17 CFR 240.15Ba1-1(h).

60 See letters from SIFMA, dated September 11, 2015 (commenting that the need for an exception to the ban was particularly acute with respect to transactions between a municipal advisor/broker-dealer and its municipal entity client in fixed income securities since "nearly all transactions in fixed-income securities are effected on a principal basis"); GFOA, dated September 14, 2015 (commenting that municipal entities might be subject to additional costs regarding advice on "investments that are not considered to be risky"); and FSI, dated September 11, 2015 (suggesting that an exception to the ban for

relevant bond documents or a particular municipal entity's investment policies, but, in such cases, the restrictions in the bond documents or the municipal entity's investment policies would appropriately control.[61]

To comply with proposed SM .14(d), a municipal advisor would have two options. These two options draw, as generally urged by commenters, upon the procedural requirements in Section 206(3) of the Advisers Act[62] and Advisers Act Rule 206(3)-3T(a),[63] respectively. Under the first option, which is set forth in proposed SM .14(d)(1), a municipal advisor would be required, on a transaction-by-transaction basis, to disclose to the municipal entity client in writing before the completion of the principal transaction the capacity in which the municipal advisor is acting and obtain the consent of the client to such transaction.[64]

Alternatively, a municipal advisor could comply with proposed SM .14(d)(2) by meeting six requirements, as set forth in proposed SM .14 (d)(2)(A) through (F). Under proposed

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broker-dealers providing advice incidental to securities execution services be limited to transactions in a similar group of fixed income securities).

61 The terms "U.S. Treasury security," "agency debt security" and "corporate debt security," and related terms, "agency," "government-sponsored enterprise," "money market instrument" and "securitized product" would be defined for purposes of new proposed SM .14 and SM .15 in proposed SM .15.

62 15 U.S.C. 80b-6(3).

63 17 CFR 275.206(3)-3T(a).

64 Consent would mean informed consent, and in order to make an informed consent, the municipal advisor, consistent with its fiduciary duty, would be required to disclose specified information, including the price and other terms of the transaction, as well as the capacity in which the municipal advisor would be acting. "Before completion" would mean either prior to execution of the transaction, or after execution but prior to the settlement of the transaction. These parameters are substantially similar to long-standing interpretive guidance regarding Section 206(3) of the Advisers Act (15 U.S.C. 80b-6(3)). See Investment Adviser Act Release No. 1732 (July 17, 1998) (SEC Interpretation of Section 206(3) of the Investment Advisers Act of 1940) ("The protection provided to advisory clients by the consent requirement of Section 206(3) would be weakened, however, without sufficient disclosure of the potential conflicts of interest and the terms of a transaction. In our view, to ensure that a client's consent to a Section 206(3) transaction is informed, Section 206(3) should be read together with Sections 206(1) and (2) to require the adviser to disclose facts necessary to alert the client to the adviser's potential conflicts of interest in a principal . . . transaction." (footnotes omitted)).

SM .14(d)(2)(A), neither the municipal advisor nor any of its affiliates could be the issuer, or the underwriter, of a security that is the subject of the principal transaction. Under proposed SM .14(d)(2)(B), the municipal advisor would be required to obtain from the municipal entity client an executed written, revocable consent that would prospectively authorize the municipal advisor directly or indirectly to act as principal for its own account in selling a security to or purchasing a security from the municipal entity client, so long as such written consent were obtained after written disclosure to the municipal entity client.[65] Proposed SM .14(d)(2)(C), would require the municipal advisor, prior to the execution of each principal transaction, to: (i) inform the municipal entity client, orally or in writing, of the capacity in which it may act with respect to such transaction and (ii) obtain consent from the municipal entity client, orally or in writing, to act as principal for its own account with respect to such transaction.

Under proposed SM. 14(d)(2)(D), a municipal advisor would be required to send a written confirmation at or before completion of each principal transaction, and a conspicuous, plain English statement making certain disclosures to the municipal entity client.[66] Under proposed SM .14(d)(2)(E), a municipal advisor would be required to send its municipal entity client, no less frequently than annually, written disclosure containing a list of all transactions that were executed in the client's account in reliance upon the Exception, and the date and price of the transactions. Under proposed SM.14(d)(2)(F), each such written disclosure would be required to include a conspicuous, plain English statement regarding the ability of the municipal entity client to revoke the prospective written consent to principal transactions without penalty at any time.

As noted above, a municipal advisor's use and compliance with the requirements of the Exception would not be construed as relieving it in any way from acting in the best interest of its municipal entity client nor from any obligation that may be imposed by the Exchange Act, other provisions of Proposed Rule G-42 (other than subsection (e)(ii) of the Proposed Rule), or other applicable provisions of the federal securities laws and state law.

The Exception will provide a useful, practical structure for a municipal advisor that is otherwise prohibited from engaging in a principal transaction with its municipal entity client to

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65 The written disclosure would be required to set forth: (i) the circumstances under which the municipal advisor directly or indirectly may engage in principal transactions; (ii) the nature and significance of conflicts with the municipal entity client's interests as a result of the transactions; and (iii) how the municipal advisor addresses those conflicts.

66 The written confirmation would be required to include the information required by Exchange Act Rule 10b-10 (17 CFR 240.10b-10) or MSRB Rule G-15, and the conspicuous, plain English statement would be required to state that the municipal advisor (i) disclosed to the client prior to the execution of the transaction that the municipal advisor may be acting in a principal capacity in connection with the transaction and the client authorized the transaction and (ii) sold the security to, or bought the security from, the client for its own account.

follow. With the inclusion of the Exception, the MSRB believes that the commenters' concern that Proposed Rule G-42 would unnecessarily or inappropriately burden competition by limiting access to financial services, especially with respect to small and medium sized municipal entities, are substantially ameliorated.

The MSRB also believes that the Exception addresses concerns raised by certain commenters regarding the statutory requirements for MSRB rules. The MSRB believes that the proposed ban, which is narrowly targeted, as modified by the Exception, is reasonably designed to maintain necessary protections for municipal entities, investors, and the public while ensuring that issuers will continue to have access to a competitive market. The Exception, in large part incorporating procedural requirements adapted from the existing federal regime for investment advisers, would allow municipal advisors to engage in principal transactions that are commonly and frequently executed on behalf of municipal entities by municipal advisors that are also broker-dealers, and, generally would not inhibit or restrict competition among providers of those types of services.

Because the MSRB believes that the costs and risks associated with municipal advisors engaging in principal transactions that are the same, or directly related to the issue of municipal securities or municipal financial product as to which the municipal advisor is providing or has provided advice (and not covered by the Exception) are so significant, and because the MSRB believes there are no reasonable alternatives to prohibition to mitigate adequately these risks and costs, any burdens on competition that the ban, with the Exception, would create are necessary and appropriate to achieve the purposes of the Exchange Act. As noted previously, the MSRB is unable to offer a quantitative estimate of the resulting burden on competition assuming the Exception, as the MSRB is unaware of, and has not been provided, any data that would support quantification.

General Comments on Principal Transaction Ban

In response to Amendment No. 1 or the OIP, several commenters expressed the view that the Proposed Rule was inconsistent with certain provisions of the Exchange Act. Cooperman, NAMA and SIFMA commented that the Proposed Rule is inconsistent with Section 15B(b)(2)(L)(iv) of the Exchange Act,[67] which requires that the MSRB, in rulemaking regarding municipal advisors, 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, and municipal entities, provided that there is robust protection against fraud.[68] Cooperman suggested that the MSRB could ease the burden on smaller municipal advisors by providing more specific guidance as to the scope of the requirements and restrictions in the Proposed Rule. NAMA believed that as

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67 15 U.S.C. 78o-4(b)(2)(L)(iv).

68 See letters from Cooperman, dated September 9, 2015; NAMA, dated September 11, 2015; and SIFMA, dated September 11, 2015.

a result of the Proposed Rule, municipal advisors would have to devote significant time and resources to establish procedures to comply with what it termed "vague and broad" rules. In NAMA's view this will be particularly burdensome for smaller municipal advisors. SIFMA also commented that municipal entity clients (in particular small municipal entity clients) would be acutely and adversely affected by the Proposed Rule because, in its view, the number of municipal advisors with which the municipal entity could engage would be limited to the point that the municipal entity would not have adequate access to a municipal advisor or would only have the requisite access at an unnecessarily high cost to the municipal entity client.

In response to Amendment No. 1 or the OIP, Cooperman, GFOA, ICI and SIFMA questioned the adequacy of the MSRB's economic analysis of the Proposed Rule.[69] Cooperman believed that the MSRB did not follow its own policy to conduct an economic analysis with respect to Proposed Rule G-42. Cooperman also believed that the MSRB did not gather data on the economic impact of the regulatory regime under Proposed Rule G-42. Rather, according to Cooperman, the MSRB reached its conclusions based on "unsubstantiated broad brush economic consequences."[70] GFOA and SIFMA similarly stated their views that the MSRB provided no economic analysis in concluding that the benefits of Proposed Rule G-42 outweigh the potential costs. ICI commented that the MSRB failed to analyze the potential economic impact of, and asked if there were an unreasonable or unnecessary burden in connection with, the proposed requirement that a municipal advisor undertake a reasonable investigation to determine that it is not basing any recommendation on materially inaccurate or incomplete information, which includes information provided by the municipal advisor's client.

In response to Amendment No. 1 or the OIP, SIFMA stated that Proposed Rule G-42 was inconsistent with Section 15B(b)(2)(C) of the Exchange Act as to the requirement that an MSRB rule not "impose any burden on competition not necessary or appropriate."[71] In its view, the Proposed Rule is overly burdensome, overly broad,

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69 See letters from Cooperman, dated September 9, 2015; GFOA, dated September 14, 2015; ICI, dated September 11, 2015; and SIFMA, dated September 11, 2015.

70 See Cooperman letter, dated September 9, 2015.

71 Section 15B(b)(2)(C) of the Exchange Act requires the MSRB to assess a number of considerations when engaging in rulemaking. In pertinent part, it requires that the rules of the MSRB, shall, as a minimum:

> be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . 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; and not be designed to permit unfair discrimination among customers,

introduces unnecessary costs, and would lead to an inappropriate reduction in competition in the municipal advisory marketplace. In addition, SIFMA indicated that it has observed municipal advisors exiting the municipal advisory business in anticipation of the implementation of the Proposed Rule and that this has already resulted in reduced competition in the municipal advisory industry. SIFMA stated that the Proposed Rule, in its view, would result in less competition in the municipal advisory industry, increased costs to issuers and fewer services available to issuers of municipal securities. SIFMA also commented that the MSRB could "achieve the same objectives without burdening competition" by revising Proposed Rule G-42 consistent with SIFMA's prior comments.[72]

NAMA, subsequently (in response to Amendment No. 2) commented that it "supports the current proposed Rule and urges the SEC to approve it in its current form without further erosion of the important principal transaction ban that is in place to protect investors."[73] Although NAMA again noted its opposition to the creation of an exception from the principal transaction ban, NAMA urged the SEC to approve the Proposed Rule, in part because the rulemaking process had given the SEC, the MSRB, respective representatives of the various interests in the municipal markets and issuers of municipal securities the opportunity to thoroughly consider the rule, and included an "extensive public comment process."[74] In NAMA's view, "the proposed amendments are sufficiently composed to still accomplish the Rule's objective in light of the difficulties principal transactions raise." NAMA also believed that "[f]urther delaying the Rule's implementation goes against the very nature and intended outcome of the Rule: to ensure that clear lines are in place, [m]unicipal [a]dvisors are properly serving their clients in accordance with their fiduciary duty, and maintaining the MSRB's overall mission to protect issuers."[75]

> municipal entities, obligated persons, municipal securities brokers, municipal securities dealers, or municipal advisors, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged . . . or to impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title.

15 U.S.C. 78o-4(b)(2)(C) (emphasis added).

72 See SIFMA letter, dated September 11, 2015.

73 See NAMA letter, dated December 7, 2015.

74 See id.

75 See id.

In response to the concerns regarding the MSRB's economic analysis of the impact of Proposed Rule G-42, the MSRB notes that throughout the development of the Proposed Rule, the MSRB rigorously followed its Policy on the Use of Economic Analysis in MSRB Rulemaking ("MSRB Policy").[76] In particular, the MSRB sought relevant data from industry participants and commenters on multiple occasions in accordance with the Policy's reference to the SEC's Current Guidance on Economic Analysis in SEC Rulemakings ("SEC Guidance"),[77] which "stresses the need to attempt to quantify anticipated costs and benefits . . . " (emphasis added) but notes that "data is necessary" to do so.[78] Despite these requests, the MSRB received no data - imperfect or otherwise - or other information, which would support any additional quantification of the impact of the Proposed Rule. In the proposed rule change, the MSRB noted this lack of data to explain why further quantification could not be supported.[79] In the absence of relevant data, consistent with the MSRB Policy and SEC Guidance, the MSRB conducted a qualitative evaluation of the benefits and costs of the Proposed Rule based significantly on the SEC's analysis of the municipal advisor market included in the SEC's final rule on the permanent registration of municipal advisors.[80] In its analysis, the MSRB concluded that the market for municipal advisors likely would remain competitive despite the potential exit of some

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76 See MSRB, Policy on the Use of Economic Analysis in MSRB Rulemaking, http://msrb.org/About-MSRB/Financial-and-Other-Information/Financial-Policies/Economic-Analysis-Policy.aspx.

77 See SEC Memorandum Re: Current Guidance on Economic Analysis in SEC Rulemakings (dated March 16, 2012), https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

78 See First Request for Comment at 25 ("Commenters are encouraged to provide supporting data, studies, or other information related to their views of the economic effects of the draft rule. In particular, the MSRB welcomes any information regarding the potential to quantify likely benefits and costs."); Second Request for Comment at 23 ("[T]he MSRB particularly welcomes any statistical, empirical and other data from commenters that may support their views and/or support or refute the views or assumptions contained in this request for comment.").

79 See Notice of Proposed Rule G-42, 80 FR at 26784 ("No commenter provided specific cost information or data that would support an improved estimate of the costs of compliance.").

80 See Registration of Municipal Advisors, Exchange Act Release No.70462 (September 20, 2013), 78 FR 67467, at 67608 (November 12, 2013) ("SEC Final Rule"). This letter necessarily assumes a working familiarity with the SEC Final Rule.

municipal advisors (including small entity municipal advisors), consolidation of municipal advisors or lack of new entrants into the market.

Commenters' observations that, as a result of the Proposed Rule, some municipal advisors may have exited the market and some issuers may be experiencing less competition do not provide a basis for revising the MSRB's prior assessments of the potential impacts of the Proposed Rule for several reasons. First, commenters have not provided data to support their observations. Second, to the extent municipal advisors have exited the market, commenters have not provided evidence to support a conclusion that they have done so in anticipation of a Proposed Rule rather than, for example, in reaction to the Dodd-Frank Act itself, the subsequent registration requirements, or the professional qualification requirements, all of which were properly included in the baseline against which the impacts of the Proposed Rule were assessed. Finally, the commenters have not provided evidence that the exit of any municipal advisor has in fact decreased competition, increased cost or resulted in reduced advisory services.

Specifically with regard to the impact of the Proposed Rule on small municipal advisors, the MSRB discussed the potential burdens on smaller advisory firms at length and concluded that the likely costs represented only those necessary to achieve the purposes of the Exchange Act.[81] The MSRB is not aware of alternatives—and commenters have not proposed any—that would reduce the burden on small municipal advisor firms while achieving the same regulatory objectives, including what the MSRB believes is the appropriate balance between principles-based provisions and more specifically prescriptive provisions.

Also in response to Amendment No. 1 or the OIP, several commenters indicated their view that the Proposed Rule was inconsistent with the Exchange Act in connection with the principal transaction ban if such ban remained as proposed, without any exceptions or modifications. As explained in detail above in the discussion of comments on the subject of principal transactions, the MSRB, in Amendment No. 2, addressed the primary concerns by adding the Exception. The MSRB believes that the Exception is responsive to the commenters' concerns that, in connection with the proposed ban, Proposed Rule G-42 is inconsistent with the Exchange Act.[82]

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81 See Notice of Proposed Rule G-42, 80 FR at 26759-60 (statement on burden on competition). See also id. at 26784-85 (economic analysis).

82 See letters from BDA, dated September 11, 2015; FSI, dated September 11, 2015; Millar Jiles, dated September 11, 2015; SIFMA, dated September 11, 2015; and Zions, dated September 10, 2015, containing statements that the Proposed Rule, with the proposed principal transaction ban, is inconsistent with one or more of the following Exchange Act provisions: Section 15B(b)(2)(L); Section 15B(b)(2)(L)(i); Section 15B(b)(2)(C); and Section 3(f).

Principal Transaction Ban – Comments on the Exception

In response to Amendment No. 2, the SEC received five comment letters, from BDA, FSI, GFOA, NAMA and SIFMA, commenting on the principal transaction ban and the Exception.[83] Two commenters, BDA and SIFMA, stated that, even with the addition of the Exception, the SEC should disapprove Proposed Rule G-42. After carefully considering each of the comments on the matter, the MSRB believes that the Exception should be retained as proposed.

Relevant Context for Addition of the Exception

For purposes of evaluating the scope of the Exception and the comments that oppose the Exception, it is essential to consider the context in which these issues arise. First, these issues arise with respect to a limited type of the diverse set of activities that constitute municipal advisory activity. In basic summary, municipal advisory activity includes advising with respect to the structure, timing and terms of an issuance of municipal securities; advising with respect to municipal derivatives; soliciting a municipal entity; and advising with respect to either the investment of proceeds of municipal securities or municipal escrow investments.[84] The issues related to the Exception arise predominantly in regard to the last listed type of advisory activity. Significantly, the SEC initially proposed to define municipal advisory activity to include advising with respect to the investment of any and all funds held by or on behalf of a municipal entity, but, in response to comments, ultimately adopted a much narrower approach focusing only on municipal bond proceeds and municipal escrow investments.[85]

Second, advising with respect to the investment of municipal bond proceeds or municipal escrow investments falls under the municipal advisor regulatory regime only if no exclusion or exemption is available. If the firm is an investment adviser registered under

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83 See letters from BDA, dated December 1, 2015; FSI, dated December 1, 2015; GFOA, dated December 1, 2015; NAMA, dated December 7, 2015; and SIFMA, dated December 1, 2015.

84 See generally SEC Final Rule.

85 See Exchange Act Rule 15Ba1-1(d)(3)(vii); SEC Final Rule, 78 FR at 67478-80 (discussing the "advice" standard in general); id. at 67490-95 (discussing plans or programs for the investment of the proceeds of municipal securities); id. at 67495 (defining "investment strategies" to include "the recommendation of and brokerage of municipal escrow investments").

the Advisers Act, the giving of investment advice on the investment of proceeds of municipal securities and municipal escrow investments can be excluded.[86] If the municipal entity makes a qualifying request for proposals ("RFP") or request for qualifications ("RFQ") on the investment of proceeds of municipal securities or on municipal escrow investments, or a qualifying mini-RFP or mini-RFQ, the giving of advice in response can be exempt.[87] If the municipal entity relies on the advice of an independent registered municipal advisor ("IRMA") with respect to the same aspects of the investment of proceeds of municipal securities or municipal escrow investments, the firm's giving of advice can be exempt, subject to certain procedural requirements.[88] Additionally, if a firm selling investments provides general information but no SEC-defined "advice," then the firm need not rely on any exclusion or exemption at all.[89]

It is generally only beyond all of these scenarios that a firm could be subject to Proposed Rule G-42 and the principal transaction ban based on the providing of advice on the investment of bond proceeds or municipal escrow investments. During the various stages of this rulemaking initiative, the proposed ban has been progressively narrowed to any principal transaction with a municipal entity client that is both: (i) the same as the, or directly related to the, issue of municipal securities or municipal financial product as to which the municipal advisor is providing or has provided advice to the municipal entity and (ii) a purchase or sale of a security or entrance into a derivative, guaranteed investment contract, or other similar financial product. Despite the ban's targeted nature, the MSRB, after careful consideration and in response to many of the commenters, but over the objections of some commenters,[90] has made yet a further accommodation in the form of the Exception, under which a municipal advisor would not be specifically prohibited from transacting, for the investment of bond proceeds, in a wide range of fixed income securities as principal.

Appropriateness of the Exception – Generally

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86 See Section 15B(e)(4)(C) of the Exchange Act; Exchange Act Rule 15Ba1-1(d)(2)(ii); SEC Final Rule, 78 FR at 67517-22.

87 See SEC Final Rule, 78 FR at 67508-09.

88 See SEC Final Rule, 78 FR at 67509-11.

89 See id. at 67478-80.

90 See letters from Jeanine Rodgers Caruso, President, National Association of Independent Public Finance Advisors ("NAIPFA") dated August 25, 2014; and Laura D. Lewis, Principal, Lewis Young Robertson & Burningham, Inc. ("Lewis Young"), dated August 25, 2014, in response to the Second Request for Comment.

NAMA supported the Proposed Rule, as amended by Amendment No. 1 and Amendment No. 2, and urged the SEC to approve it "without further erosion of the important principal transaction ban that is in place to protect issuers."[91] NAMA emphasized its belief in the importance of the duties and obligations present in municipal advisors' relationships with their clients, including the fiduciary duty to municipal entity clients. NAMA noted that it, like other market participants, has certain concerns with aspects of the Proposed Rule, but pointed to the "thorough consideration" of the Proposed Rule "throughout an extensive public comment process" and urged a "balanced resolution" of the concerns animating the Dodd-Frank Act and the protections intended by that Act. NAMA stated its belief that the Exception is sufficient to accomplish the Proposed Rule's objective "in light of the difficulties principal transactions raise." NAMA commented that further delaying the Proposed Rule's implementation would be contrary to the purposes of the Proposed Rule, including to help ensure that municipal advisors are properly serving their clients in accordance with their fiduciary duty and to further the MSRB's mission to protect municipal entities.

SIFMA commented that the Exception shows movement toward a more workable construct than the complete principal transaction ban, but that "importing into the Exception all of the procedural accoutrements of Section 206(3) and Rule 206(3)-3T, adopted in another context," has resulted in the Exception being unreasonably limited and unworkable in practice.[92] SIFMA also commented that the Exception's requirements for the alternative under proposed SM .14(d)(2) to obtain additional transaction-by-transaction consent undermines the utility of obtaining advance written consent, and presents challenging issues of documentation and recordkeeping. SIFMA stated that it would present unworkable challenges to the municipal advisor and municipal entities that may seek to execute ordinary course transactions "several times per day or more." SIFMA stated that the procedural requirements included in proposed SM .14(d)(2), in the context of Advisers Act Rule 206(3)-3T,[93] have discouraged broker-dealers from relying on that rule and have limited its ultimate utility.

BDA acknowledged that the Exception has addressed what it termed "marginal considerations surrounding the principal transactions ban," but, in its view, an exception would not be "meaningful and useful" unless the municipal advisor could "provide[] advice to the municipal entity in connection with the issuance of municipal securities the proceeds of which are being invested."[94] BDA also commented that the consent and disclosure

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91 See NAMA letter, dated December 7, 2015.

92 See SIFMA letter, dated December 1, 2015.

93 17 CFR 275.206(3)-3T.

94 See BDA letter, dated December 1, 2015.

requirements are too burdensome to be useful, and, as a practical matter, the provisions would require transaction-by-transaction written consent since the alternative (to obtaining such consents) is too extensive to make it worth a dealer's effort. BDA recognized that the MSRB followed the principles in the investment adviser context, but believed that the approach "does not take into consideration the vast differences between brokerage operations and investment advisory operations."[95]

Responsiveness of the Exception to Comments

As explained in Amendment No. 2, the MSRB crafted the Exception to the principal transaction ban drawing on Section 206(3) of the Advisers Act[96] and the IA Rule. The MSRB's approach was influenced by a number of considerations, and highly important among them were the recurring urgings by commenters during the development of Proposed Rule G-42 that the MSRB look to the regulatory regime applicable to investment advisers that provides such advisers the ability to engage in principal transactions with their clients, subject to requirements that include providing full disclosure and obtaining informed consent. Numerous commenters cited the approach for investment advisers in response to the First Request for Comment, Second Request for Comment, the Notice of Proposed Rule G-42, and the OIP and Amendment No. 1.[97]

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95 See id.

96 15 U.S.C. 80b-6(3).

97 See, in response to the First Request for Comment, letters from Cristeena G. Naser, Vice President and Senior Counsel, American Bankers Association ("ABA"), dated March 4, 2014; Michael Nicholas, Chief Executive Officer, BDA, dated March 10, 2014; Paul N. Palmeri, Managing Director, JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC (collectively "JPMorgan"), dated March 10, 2014; Robert A. Lamb, President, Lamont Financial Services Corporation ("Lamont"), dated March 10, 2014; Allen K. Robertson, President, National Association of Bond Lawyers ("NABL"), dated March 18, 2014; Leslie M. Norwood, Managing Director and Associate General Counsel, SIFMA, dated March 10, 2014; Michael B. Koffler, Sutherland Asbill & Brennan LLP ("Sutherland"), dated March 10, 2014; and Robert J. McCarthy, Director of Regulatory Policy, Wells Fargo Advisors, LLC ("Wells Fargo"), dated March 10, 2014. See also, in response to the Second Request for Comment, letters from Richard Foster, Vice President and Senior Counsel for Regulatory and Legal Affairs, Financial Services Roundtable ("FSR"), dated August 25, 2014; Peter W. LaVigne, Chair, New York State Bar Association, dated August 27, 2014; Leslie M. Norwood, Managing Director and Associate General Counsel, SIFMA, dated August 25, 2014; and W. David Hemingway, Executive Vice President, Zions, dated August 25, 2014. See also, in response to the Notice of Proposed Rule G-42, letters from David T. Bellaire, Executive Vice President and General Counsel, FSI, dated May 29, 2015; Leslie M. Norwood, Managing Director

These comments included several by SIFMA and BDA, which have since commented that they oppose approval of Proposed Rule G-42 with the inclusion of the Exception. In response to the First Request for Comment, SIFMA specifically cited Section 206(3) and stated:

> Even investment advisers, which have long been recognized as owing a fiduciary duty and the utmost good faith in dealings with their clients, are not subject to an immutable prohibition on transacting with a client as principal. Rather, consistent with its fiduciary duty, an investment adviser and its affiliates may engage in a principal transaction with a client so long as the adviser obtains the client's consent after disclosing the capacity in which the adviser will act, any compensation the adviser will receive and any other relevant facts.[98]

In response to the Second Request for Comment, SIFMA urged an exception for principal transactions in fixed income securities and stated that its rationale was similar to the SEC's rationale for adopting the IA Rule, specifically citing that rule and the SEC's adopting release for the rule.[99] In response to the Notice of Proposed Rule G-42, SIFMA criticized the Proposed Rule as "anti-competitive" and the principal transaction ban specifically as "inconsistent with other fiduciary duty and similar regimes," and commented that broker-dealers that are investment advisers are not subject to such a prohibition on transacting with a client as principal, specifically citing Section 206(3).[100] In response to the OIP and Amendment No. 1, SIFMA stated that municipal entities should be viewed as equally "capable of evaluating and consenting to fully and fairly disclosed conflicts of interest" as Congress and the SEC have viewed retail investors under the Adviser's Act, and directed the MSRB to the IA Rule as an approach adopted by the SEC

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and Associate General Counsel, SIFMA, dated May 28, 2015; and W. David Hemingway, Executive Vice President, Zions, dated May 29, 2015. See also, in response to the OIP or Amendment No. 1, letters from Michael Nicholas, CEO, BDA, dated September 11, 2015 and November 4, 2015; David T. Bellaire, Executive Vice President and General Counsel, FSI, dated September 11, 2015; Lindsey K. Bell, Millar Jiles, dated September 11, 2015; Leslie M. Norwood, Managing Director and Associate General Counsel, SIFMA, dated September 11, 2015; and W. David Hemingway, Executive Vice President, Zions, dated September 10, 2015.

98 See SIFMA letter, dated March 10, 2014 (footnote omitted).

99 See SIFMA letter, dated August 25, 2014.

100 See SIFMA letter, dated May 28, 2015.

to permit investment advisers to engage in principal transactions with their advised clients.[101]

BDA, in its first letter in response to the OIP and Amendment No. 1, stated:

> The proposal that certain principal transactions be banned is out of step with how the duty of loyalty is managed with other fiduciaries—such as directors and officers, investment advisers, and attorneys. With other fiduciaries, the identification of a conflict of interest does not give rise to an outright ban but instead is managed through a disclosure and consent process.
>
> For example, the conflict management process for investment advisers is typical of the process for other fiduciaries. With investment advisers, under Section 206(3) of the Investment Advisers Act of 1940, an investment adviser – a fiduciary – is prohibited from executing principal transactions with a client, "without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction." This requirement is applicable on a trade-by-trade basis, which allows the client to assess the nature of the conflict associated with each transaction. Advisers Act Rule 206(3)-3T, applicable to principal transactions executed by dual registrants, requires a five-step framework of (1) disclosure of conflicts associated with principal trades, (2) the provision of written, revocable consent from the client authorizing the transaction, (3) pre-trade consent, (4) post-trade confirmation statement disclosure, and (5) an annual report of principal transactions executed on the clients behalf.[102]

In its second letter in response to the OIP and Amendment No. 1, BDA reiterated that it believed, in the area of principal transactions, "the potential for abuse should be principally addressed through the design of a framework and a rigorous, transparent, and accountable process and not through an outright ban."[103] BDA further commented:

> [S]ome dealers form very narrow municipal advisory relationship[s] in connection with the trading of securities so that the municipal entity or obligated person may obtain recommendations concerning how to invest proceeds from issuances of municipal securities or escrow investments. This kind of relationship is a very different relationship than the typical financial advisory relationship in

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101 See SIFMA letter, dated September 11, 2015.

102 See BDA letter, dated September 11, 2015 (footnote omitted).

103 See BDA letter, dated November 4, 2015.

> bond transactions, and is much more closely aligned with the kinds of relationships and conflicts encountered by investment advisers. . . . [T]he principal transaction ban . . . would be much more rigid than the process currently followed under the investment advisors regulatory regime, which we do not believe is appropriate.[104]

In response to the consistent and repeated urgings from numerous commenters during the development of Proposed Rule G-42, including BDA and SIFMA, that the MSRB look to the regulatory regime applicable to investment advisers, frequently citing Section 206(3) and the IA Rule in particular, the MSRB drew upon those provisions in its development of Amendment No. 2. None of those commenters, prior to the incorporation of the Exception, suggested that an approach for municipal advisors like that applicable to investment advisers would not be useful, workable or meaningful. In response to the OIP, FSI suggested consistency with the IA Rule and specifically addressed this issue, stating that the IA Rule strikes a "balanced approach that ensures customers maintain the protections of the fiduciary duty while preserving their ability to benefit from principal transactions."[105]

Usefulness, Workability and Meaningfulness of the Exception

In addition to its interest in being responsive to commenters, the MSRB specifically drew on the IA Rule as one option for municipal advisors under proposed SM .14(d)(2) because it was developed by the SEC (as the primary regulator of the securities markets), has been in place for the lengthy period of eight years, and has been repeatedly considered through notice-and-comment rulemaking procedures upon adoption and in connection with four extensions of the rule. Moreover, it has been consistently considered by representatives of the industry to be operating as intended, well protecting investors, and extensively relied upon.

In support of its recent comment that similar procedural requirements to those in proposed SM .14(d)(2) have discouraged broker-dealers from relying on the IA Rule and ultimately limited its utility, SIFMA cites a 2010 letter from SEC staff stating the staff's understanding that "'few firms'" rely on the rule.[106] That letter contained the SEC staff's understanding prior to the SEC's receipt of public comment on the matter, after which the

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104 See id.

105 See FSI letter, dated May 29, 2015.

106 See SIFMA letter, dated December 1, 2015 (quoting letter from Andrew J. Donohue, Director, SEC Division of Investment Management, to Ira D. Hammerman, Esq., Senior Managing Director and General Counsel, SIFMA (August 9, 2010), available at https://www.sec.gov/rules/final/2009/ia-2965a-sifma-letter.pdf).

SEC made a second extension of the rule, and then two additional extensions for two years each.

In the public commentary on the matter, SIFMA supported the second extension, with detailed data, informing the SEC that "firms both large and small have relied upon, and investors have benefitted from, the Rule."[107] SIFMA also stated that "allowing principal trading under manageable and appropriate protections such as those of the Rule promotes investor choice in advisory accounts with access to the inventory of a diversified financial services firm."[108]

In 2012, SIFMA supported the third extension of the rule, reporting that "reliance on the Rule is extensive."[109] SIFMA again provided detailed supporting data, reporting that, during the previous two years, just seven firms surveyed (out of a total of 125 dual registrants) "have engaged in principal trades in reliance on the Rule with 106,682 of [the eligible] accounts and have executed an average of 12,009 principal trades per month in reliance on the Rule."[110] In 2014, SIFMA supported the fourth extension of the IA Rule, stating that "it is extensively relied upon by dual registrants and investors, and it benefits investors."[111] SIFMA further stated that its "member firms that continue to rely on the Rule trade a wide variety of securities, including fixed income securities . . . ."[112]

In its comment letter, GFOA expressed a concern that the procedural requirements of the Exception would be too complex or burdensome and render the relief intended to be granted "illusory."[113] GFOA expressed a concern that this has proved to be the case with

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107 See letter to Elizabeth M. Murphy, Secretary, SEC, from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, Temporary Rule Regarding Principal Trades with Certain Advisory Clients, dated December 20, 2010, at 2.

108 Id.

109 See letter to Elizabeth M. Murphy, Secretary, SEC, from Kevin M. Carroll, Managing Director and Associate General Counsel, SIFMA, Temporary Rule Regarding Principal Trades with Certain Advisory Clients, dated November 13, 2012, at 3.

110 Id.

111 See letter to Brent J. Fields, Secretary, SEC, from Kevin M. Carroll, Managing Director and Associate General Counsel, SIFMA, Temporary Rule Regarding Principal Trades with Certain Advisory Clients, dated September 17, 2014, at 4.

112 Id. at 2, n.5.

113 See GFOA letter, dated December 1, 2015.

similar requirements that apply to principal transactions by investment advisers. GFOA acknowledged, however, that in some respects it would "need feedback from dealers before reaching [a] conclusion" regarding the workability of the Exception, recognizing that its members are, of course, not broker-dealers.[114] It is clear, however, as explained above, from repeated commentary by representatives of broker-dealers and supporting data, that similar provisions for investment advisers have been manageable and relied upon extensively, providing an ample basis to believe that the similar approach in proposed SM .14(d)(2) will be useful and workable for a significant portion of those firms that wish to use an option under the Exception.

BDA commented, that the Exception will not be "meaningful" or "useful" unless the municipal advisor can "provide[] 'advice' to the municipal entity in connection with the issuance of municipal securities the proceeds of which are being invested."[115] This type of scenario, however, raises precisely the acute conflicts of interest and heightened risk of self-dealing related abuses about which the MSRB is concerned, and the MSRB does not believe such scenarios should be excepted from the specific prohibition of proposed G-42(e)(ii).

While BDA also commented that the Exception "does not take into consideration the vast differences between brokerage operations and investment advisory operations," it did not specify what differences would be relevant here or would support a revision of the Exception.[116] As noted, many commenters, including BDA, repeatedly observed parallels between municipal advisor/broker-dealers, on the one hand, that might advise on the investment of bond proceeds and provide securities brokerage services and investment advisers, on the other hand, that engage in principal transactions with their clients. Indeed, as noted above, BDA previously commented that the broker-dealer relationship with a municipal entity in connection with the investment of bond proceeds is "more closely aligned with the kinds of relationships and conflicts encountered by investment advisers."[117]

The MSRB believes that in most situations, the role of broker-dealer operations will be common to each scenario. An investment adviser that is engaging in a principal transaction generally will be a broker-dealer. Indeed, an investment adviser that is relying on the IA Rule must, as a condition of that rule, be a broker-dealer, and the IA Rule was specifically designed to accommodate dually registered broker-dealer/investment advisers.

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114 Id.

115 See BDA letter, dated December 1, 2015.

116 Id.

117 See BDA letter, dated November 4, 2015.

The primary difference relevant to the operations between the two scenarios, therefore, will be that in one the firm is a municipal advisor and in the other it is an investment adviser. To make use of the Exception, a broker-dealer would need to have operational ability similar to that needed by an investment adviser to rely upon the IA Rule, or otherwise make disclosure and obtain consent in compliance with Section 206(3). It is unclear, however, how the MSRB could create an exception to the principal transaction ban for municipal advisors similar to the regulatory framework for investment advisers as many commenters urged, including BDA, without this result.

At a general policy level, an important consideration in the MSRB's addition of the Exception was the concern, expressed by some, and strongly implied by many others, that the lack of any exception from the ban for transactions in fixed income securities to invest bond proceeds would inappropriately put municipal advisors at a competitive disadvantage compared with investment advisers. For example, in response to the First Request for Comment, SIFMA, noting the exclusion from the municipal advisor definition for investment advisers, stated that, in its view, Congress had incorporated the exclusion because it believed that investment adviser clients were adequately protected by the investment adviser regulatory scheme, which included disclosure and consent provisions.[118] SIFMA believed that it would be "anomalous" if the MSRB adopted a rule "that prohibited a municipal advisor from engaging in principal transactions—while the exact same transaction would be permissible for a registered investment adviser engaging in the exact same advisory activity."[119] Similarly, Zions previously noted the exclusion for investment advisers and suggested that the regulation of the same conduct in connection with principal transactions for municipal advisors should be consistent with that for investment advisers.[120] The MSRB believes the Exception is responsive to these comments and it is designed to mitigate these concerns. To reduce the municipal entity protections included in the Exception that draw on the investor protections in the investment adviser framework, however, would risk the same problem that commenters identified, except that investment advisers could be put at a competitive disadvantage to municipal advisors.

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118 See SIFMA letter, dated March 10, 2014.

119 See id. See also, in response to the Notice of Proposed Rule G-42, letters from SIFMA, dated May 28, 2015 (commenting that the Proposed Rule is "anti-competitive"), and dated September 11, 2015 (same).

120 See Zions letter, dated May 29, 2015.

Requests for Clarification Regarding Exception

In response to Amendment No. 2, GFOA sought clarification on several matters, on which it appeared additional guidance would help allay GFOA's concerns regarding whether broker-dealers would find the Exception workable.

Form of Communications. GFOA asked whether the consent required to be obtained under proposed SM .14(d)(1) may be oral as opposed to written.[121] Proposed SM .14(d)(1) requires the municipal advisor to "disclose[] to the municipal entity client in writing before the completion of the transaction the capacity in which the municipal advisor is acting and obtain[] the consent of the municipal entity client to such transaction." According to the terms of the provision, the disclosure must be "in writing," but there is no such requirement for the client consent that must be obtained, which may be oral. Proposed SM .14(d)(1), as generally urged by commenters, draws on Section 206(3). Long-standing SEC staff guidance under that statute interprets it to mean client consent may be oral.[122] The MSRB has concluded that, similarly, a municipal advisor client's oral consent would be sufficient under proposed SM .14(d)(1).

GFOA also asked whether certain communications that would be required to be made in writing under the Exception may be made through email.[123] As with the similar procedural requirements in Section 206(3) and the IA Rule applicable to investment advisers, such communications may be made by email, provided the municipal advisor satisfies the same procedural conditions that the SEC applies to an investment adviser when communicating with customers via email as set forth in SEC guidance regarding the use of electronic media.[124] The MSRB has provided similar flexibility for communications between dealers and customers, including the making of disclosures.[125]

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121 See GFOA letter, dated December 1, 2015.

122 See, e.g., Dillon, Read & Co. Inc., SEC No-Action Letter, Fed. Sec. L. Rep. P 80,352 (August 6, 1975).

123 See GFOA letter, dated December 1, 2015.

124 See Securities Act Release No. 7288 (May 9, 1996), 61 FR 24644 (May 15, 1996), SEC Interpretation of Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information (listing Section 206(3) as a provision to which the interpretation applies) ("Electronic Media Guidance"); available at: https://www.sec.gov/rules/interp/33-7288.txt.

125 See MSRB Notice Regarding Electronic Delivery and Receipt of Information by Brokers, Dealers and Municipal Securities Dealers - November 20, 1998 (requiring broker-dealers to satisfy procedural conditions for electronic communications with customers that are substantially similar to those required in the SEC's Electronic Media Guidance).

Interaction of the Exception with Exclusion and Exemptions from the SEC Final Rule. GFOA asked whether a broker-dealer that has provided advice to a municipal entity based on one of the exclusions or exemptions to the definition of "municipal advisor" (e.g., the underwriter exclusion) would be able to sell investments of bond proceeds to that municipal entity as principal, assuming that the requirements of proposed SM .14 are met.[126] The MSRB assumes that, although not stated explicitly by GFOA, the firm in this scenario also would be providing advice on the investment of bond proceeds, without the availability of an exclusion or exemption for that advice. Otherwise, the firm would not be a municipal advisor to the municipal entity and subject to Rule G-42 and the principal transaction ban. A firm in this scenario would not be specifically prohibited by the principal transaction ban from selling investments of bonds proceeds to a municipal entity as principal, assuming all of the limitations and conditions of proposed SM .14 are met.

It is important to note that proposed SM .14(b) generally would make the Exception unavailable to a municipal advisor that "is providing or has provided advice to the municipal entity client as to an issue of municipal securities or a municipal financial product that is directly related to the principal transaction." This limitation, and other provisions of the Exception, should be read together with the principal transaction ban in Proposed Rule G-42(e)(ii) to which the Exception relates. As pertinent here, Proposed Rule G-42 and the principal transaction ban in subsection (e)(ii) apply where the providing of advice with respect to the issuance of municipal securities or a municipal financial product causes the provider of advice to be a "municipal advisor." "Municipal advisor" is a defined term in the Proposed Rule, incorporating all of the SEC rules that define advice and provide various exclusions and exemptions from the definition of a "municipal advisor."[127] Reading the provisions of the Proposed Rule together, as intended, the giving of advice to which an exclusion or exemption applies, would not make the Exception unavailable under the limitation in proposed SM .14(b).

As the MSRB has emphasized, however, merely because a principal transaction is not specifically prohibited by the ban does not necessarily mean it is permitted. As previously explained, a municipal advisor would need to continue to be mindful of, and comply with, its obligations under other provisions of Proposed Rule G-42, as well as all other applicable provisions of other MSRB rules and laws and regulations.[128] Additionally,

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126 BDA similarly requested that the MSRB "confirm that if a firm does provide advice pursuant [to] an exemption as outlined in the Municipal Advisor Rule, that the firm would not be precluded from selling securities under the current version of Proposed Rule G-42." See BDA letter, dated December 1, 2015.

127 See Exchange Act Rule 15Ba1-1(d)(2) and (3).

128 See Notice of Proposed Rule G-42, 80 FR at 26783. See also MSRB Response at 21.

as also previously explained, the use of the Exception does not alter this treatment. Like with the procedural requirements for an investment adviser to engage in a principal transaction with a client, compliance with the procedural requirements of the Exception would not, according to proposed SM .14, relieve "a municipal advisor from acting in the best interest of its municipal entity clients, nor shall it relieve the municipal advisor from any obligation that may be imposed by other applicable provisions of the federal securities laws and state law."[129]

Need for Professional Qualification. Lastly, GFOA asked why a broker-dealer that is a municipal advisor must, under MSRB Rule G-3,[130] pass the municipal advisor representative professional qualifications examination (Series 50) to sell "Treasuries, agencies, and corporate debt securities when bond proceeds are invested, while the Series 7 suffices for the same broker to sell the same securities to a municipal entity when the funds invested are not bond proceeds."[131]

The answer to this question is found in the definition of "municipal advisor" and a separate rulemaking initiative regarding municipal advisors and Rule G-3, on professional qualification requirements, which concluded in February 2015. The SEC, in the SEC Final Rule, determined that "any advice or recommendation with respect to the investment of proceeds not otherwise subject to an exclusion or exemption would be a municipal advisory activity, even if such advice or recommendation is not part of a series of investment-related actions or articulated as part of the investment plan for the proceeds at or before the time the proceeds are received."[132] The SEC explained that "advice or a recommendation with respect to a single trade or investment not otherwise subject to an exemption would be a municipal advisory activity, and the person providing such advice would not be exempt from the definition of municipal advisor pursuant to Rule 15Ba1-1(d)(3)(vii)."[133]

In the Rule G-3 rulemaking matter, the MSRB advanced the policy that all persons who engage in municipal advisory activities (other than a person performing only clerical,

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129 See Amendment No. 2 Notice, 80 FR at 71860 n. 18.

130 MSRB Rule G-3(d)(ii)(A) provides that: "Every municipal advisor representative shall take and pass the Municipal Advisor Representative Qualification Examination [(also known as the Series 50 Examination)] prior to being qualified as a municipal advisor representative. The passing grade shall be determined by the Board."

131 See GFOA letter, dated December 1, 2015.

132 See SEC Final Rule, 78 FR at 67493(footnotes omitted).

133 Id.

administrative, support or similar functions) should be required to pass a qualification examination to demonstrate a minimum level of knowledge of job responsibilities and regulatory requirements.[134] The MSRB specifically determined that passage of the Series 7 Examination would not suffice in part because, "the content [of that examination is not] specifically related to municipal advisory activities or the regulation of such activities."[135] The MSRB further explained that "the job responsibilities of a municipal advisor professional and the regulations governing such individuals are sufficiently distinct in application as to require [the passage of] a separate examination."[136] The SEC approved the MSRB's proposed rule change regarding Rule G-3, concluding that "[e]stablishing a baseline competence is necessary for the protection of investors, municipal entities, and obligated persons [because] it promotes compliance with the rules and regulations governing the conduct of municipal advisors."[137] Significantly, the SEC stated it did "not believe that the proposed rule change would impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act since it would apply equally to all municipal advisor representatives who engage in municipal advisory activities."[138]

Broker-Dealer Registration and Regulated Account Requirements

In response to Amendment No. 2, SIFMA expressed a concern that the Exception would be available, according to proposed SM .14(a), only to a firm that is a registered broker-dealer and only for accounts subject to the Exchange Act, and the rules thereunder, and the rules of self-regulatory organization(s) of which it is a member (e.g., the Financial Industry Regulatory Authority ("FINRA")). SIFMA stated that the registration requirement is "unnecessary" and that the policy rationale for requiring the relevant account to be

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134 See Exchange Act Release No. 73708 (December 1, 2014), 79 FR 72225, at 72227 (December 5, 2014) (File No. SR-MSRB-2014-08) (Notice of Filing of Proposed Rule Change Consisting of Proposed Amendments to MSRB Rules G-1 (Separately Identifiable Department or Division of a Bank); G-2, (Professional Qualification Standards); G-3, (Professional Qualification Requirements); and D–13, (Municipal Advisory Activities)).

135 Id. at 72231.

136 Id. at 72227.

137 See Exchange Act Release No. 74384 (February 26, 2015), 80 FR 11706, at 11710 (March 4, 2015) (File No. SR-MSRB-2014-08).

138 Id. at 11710.

subject to Exchange Act regulation is "unclear."[139] SIFMA recognized that the SEC included these same requirements in the IA Rule, but commented that these requirements only exist in that rule due to the historical context in which the decision in Financial Planning Association v. SEC ("FPA")[140] effectively required certain brokerage accounts to be treated as advisory accounts. SIFMA suggested that the Exception should be available to a firm that relies on an exemption from broker-dealer registration, such as a bank.[141]

The SEC's adopting release for the IA Rule, however, indicates that, although historical context gave the SEC occasion to consider the IA Rule, it was not the rationale for these requirements. The SEC explained that a principal consideration in including the requirements was that broker-dealers and their employees "must comply with the comprehensive set of Commission and self-regulatory organization sales practice and best execution rules that apply to the relationship between a broker-dealer and its customer . . . ."[142] The MSRB similarly considers it necessary that transactions in reliance on the Exception be executed under this comprehensive set of investor protections. The requirement that the account itself be subject to the relevant rules, in addition to the requirement that the firm be a registered broker-dealer, will help ensure this result. In response to SIFMA's concern regarding banks, the MSRB notes that the SEC has provided an exemption from the municipal advisor definition for banks providing advice on multiple subjects, which could mean that a bank engaging in particular principal transactions would not be subject to Proposed Rule G-42 at all. These subjects of advice include any investments that are held in a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank and any investment made by a bank acting in the

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139 See SIFMA letter, dated December 1, 2015.

140 Financial Planning Association v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

141 See SIFMA letter, dated December 1, 2015.

142 See Advisers Act Release No. 2653 (September 24, 2007), at 28, 72 FR 55022, at 55029 (September 28, 2007) (Temporary Rule Regarding Principal Trades with Certain Advisory Clients) ("2007 IA Rule Order"). See also Advisers Act Release No. 3128 (December 28, 2010), at 22, 75 FR 82236, at 82241 (December 30, 2010) (Temporary Rule Regarding Principal Trades with Certain Advisory Clients) ("The condition that advisers seeking to rely on the rule must also be registered as broker-dealers and that each account with respect to which an adviser seeks to rely on the rule must be a brokerage account subject to the Exchange Act, and the rules thereunder, and the rules of the self-regulatory organization(s) of which it is a member, reflect what we believe is an important element of our balancing between easing regulatory burdens (by affording advisers an alternative means of compliance with section 206(3) of the Act) and meeting our investor protection objectives.").

capacity of an indenture trustee or similar capacity (e.g., a bond indenture trustee, paying agent, or municipal escrow agent).[143]

Specific Procedural Requirements for Proposed SM .14(d)(2)

In response to Amendment No. 2, some commenters expressed concerns regarding some specific procedural requirements for use of the option under proposed SM .14(d)(2). This letter responds above to various general concerns regarding the procedural requirements under proposed SM .14(d)(2), which responses similarly apply to these comments. The MSRB addresses here the comments on the annual disclosure requirement and underwriter limitation more specifically. Importantly, as noted above, a municipal advisor that, on balance in its particular circumstances, considers the alternative provided under proposed SM .14(d)(1) comparatively more cost-effective, may make transaction-by-transaction written disclosure and obtain written or oral consent under that provision and not be subject to the additional procedural requirements under proposed SM .14(d)(2) to make use of the Exception.

Confirmation Disclosure and Annual Summary Statement Requirements. FSI and SIFMA expressed concerns regarding the requirement, as part of the option under proposed SM .14(d)(2), that the municipal advisor provide its client with an annual summary statement.[144] FSI commented that the MSRB should confirm with municipal entities that the annual disclosure listing the date and price of all principal transactions executed pursuant to the Exception would be useful to municipal entities. FSI expressed a concern that such clients already receive transaction confirmations and account statements providing such information; receive documentation and records from additional sources (such as bank custodians) concerning their holdings; and that the annual disclosure might be unnecessary. SIFMA commented that the annual disclosure requirement and the special confirmation disclosure requirements are unwieldy and duplicative. SIFMA also commented that both of these would require firms to implement costly operational changes. SIFMA further commented that it is unclear that municipal entity clients would benefit from these disclosures, having previously provided (and not having revoked) their consent to principal transactions, and receiving the ordinary confirmation disclosure required under Exchange Act Rule 10b-10 that would disclose the capacity in which the broker-dealer acted.

The MSRB believes that the Exception should not be amended to eliminate the requirements for confirmation disclosures and annual summary statements at this time.

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143 See Exchange Act Rule 15Ba1-1(d)(3)(iii). See also SEC Final Rule, 78 FR at 67533-36.

144 See letters from FSI, dated December 1, 2015, and SIFMA, dated December 1, 2015.

Like the similar requirement under the IA Rule,[145] the annual summary statement requirement is designed to ensure that clients receive a periodic record of the principal trading activity in their accounts and are afforded an opportunity to assess the frequency with which their adviser engages in such trades. Moreover, when adopted as part of the IA Rule in 2007, the concept of an annual summary of transactions involving particular conflicts of interest was not novel, as it was derived from the cross-trade rule under the Advisers Act.[146] The MSRB believes that an annual summary of all principal transactions, which are executed subject to conflicts of interest where certain disclosures have been made and consents obtained, would be particularly beneficial to officials of municipal entities, including newly elected or appointed officials who, upon their election or appointment, may be required to review thoroughly and expeditiously the municipal entity's prior transactions and relationships with financial intermediaries to determine whether the same course with the same intermediaries should continue.

The confirmation disclosure requirement, like the similar requirement under the IA Rule,[147] is designed to ensure that clients are given a written notice and reminder of each transaction that the municipal advisor effects on a principal basis and that conflicts of interest are inherent in such transactions. The Proposed Rule contains no requirement that the disclosures under the various provisions be in separate documents. Like under the IA Rule,[148] a firm relying on proposed SM .14(d)(2) need not send a duplicate confirmation and may include additional required disclosures on a confirmation otherwise sent to a customer with respect to a particular principal transaction.

Underwriter Limitation. BDA expressed a concern that the option under proposed SM .14(d)(2) would not be meaningful or useful in part because, under proposed SM .14(d)(2)(A), neither the firm nor any affiliate would be permitted to be, at the time of a sale, an underwriter of the security.[149] The MSRB believes this is an important municipal entity protection measure in scenarios where the municipal advisor is not making transaction-by-transaction written disclosure. As explained by the SEC in the context of the IA Rule, a "broker-dealer participating in an underwriting typically has a substantial economic interest in the success of the underwriting, which might be different from the

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145 See 2007 IA Rule Order, 72 FR at 55028-29 (September 28, 2007).

146 See 2007 IA Rule Order, 72 FR at 55029 (discussing the IA Rule's procedural similarity to Rule 206(3)-2—the agency cross transactions for advisory clients rule—under the Advisers Act).

147 Id. at 55026.

148 Id. at 55026.

149 See BDA letter, dated December 1, 2015.

interests of investors."[150] As the SEC further explained, the "incentives may bias the advice being provided or lead the adviser to exert undue influence on its client's decision to invest in the offering or the terms of that investment."[151] For these reasons, the SEC disagreed with requests by broker-dealers to provide principal-trading relief where they are underwriters of the securities.[152] For the same reasons, the MSRB believes the underwriter limitation in proposed SM .14(d)(2)(A) should be retained.

The Protection of Municipal Escrow Investments

SIFMA and FSI objected to the exclusion from the Exception of transactions in connection with municipal escrow investments, and suggested that the Exception be extended.[153] As previously explained, the Exception does not so extend because the MSRB believes this is an area of heightened risk where, historically, significant abuses have occurred.[154] The MSRB created the Exception in response to commenters' beliefs, including those of GFOA, that the previously proposed principal transaction ban covered conduct by municipal advisors that is significantly relatively less risky to municipal entities. Municipal escrow investments typically involve investments of large sums for long periods of time linked to call restrictions or maturities of refunded debt, making these investments particularly vulnerable to abuse.[155] In its comment letter, SIFMA acknowledges that there have been past abuses involving municipal escrow investments. In the SEC Final Rule, the SEC stated that "the potential for future pricing abuses continues to exist in this area,"[156] and made this statement notwithstanding Congress's imposition of a fiduciary duty on municipal advisors with respect to municipal entity clients approximately three years prior.

In addition to this being an area that presents relatively greater risk to municipal entities, the legitimate need for an exception from the principal transaction ban in this area

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150 See 2007 IA Rule Order, 72 FR at 55027.

151 Id. at 55026-27.

152 Id. at 55026-27.

153 See letters from FSI, dated December 1, 2015, and SIFMA, dated December 1, 2015.

154 See Amendment No. 2 Notice, 80 FR at 71860.

155 See, e.g., SEC Press Release No. 2000-45 (April 6, 2000) (announcing global "yield-burning" settlement with seventeen broker-dealers involving pricing abuses in municipal escrow investments).

156 See SEC Final Rule, 78 FR at 67496.

is likely to be lesser. The MSRB understands that the provider of municipal escrow investments, as a matter of market practice, is frequently selected through a competitive bidding process. In such situations, it would be less likely that the municipal entity would have a need for the potential investment providers to provide advice with respect to the related principal transactions. Neither SIFMA nor FSI addressed the relevance of this market practice in connection with the appropriate scope of the Exception. Additionally, depending on the facts and circumstances, if the municipal entity administers a competitive bidding process, in a manner consistent with the exception to the municipal advisor definition for any person that provides a written or oral response to an RFP or an RFQ, potential investment providers would be able to give advice in their response to the municipal entity without being a municipal advisor to the municipal entity.

Engaging in conduct involving acute conflicts of interest when providing advice with respect to either the investment of bond proceeds or municipal escrow investments is a matter of major concern. Both types of funds warrant strong protections. The MSRB believes that, having flexibly created the Exception for the investment of funds raised by municipal entities in the capital markets for public purposes, a reasonable distinction can be drawn for municipal escrows, which the SEC has defined as "proceeds of municipal securities and any other funds of a municipal entity that are deposited in an escrow account to pay the principal of, premium, if any, and interest on one or more issues of municipal securities."[157] The MSRB believes funds so deposited for the payment of issues of municipal securities warrant heightened protection, even as compared with the high level of protection warranted for proceeds of municipal securities that have not been so deposited for such purpose. The MSRB, for all of these reasons, declines the suggestion to extend the Exception to municipal escrow investments at this time.

Money Market Instruments

SIFMA commented that the Exception should extend to the purchase and sale of money market instruments, commercial paper, certificates of deposit and other deposit instruments.[158] In SIFMA's view, there is no municipal entity protection reason to exclude them. Further, SIFMA commented that, if the designated class of fixed income securities were modeled upon provisions in FINRA Rule 6710, the rationale for excluding money market instruments under FINRA Rule 6710 should "have no bearing on whether money market instruments should be eligible" for the Exception.[159]

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157 See Exchange Act Rule 15Ba1-1(h)(1) (17 CFR 240.15Ba1-1(h)(1)).

158 See SIFMA letter, dated December 1, 2015.

159 Id.

As stated in Amendment No. 2, the designated class of securities for purposes of the Exception is intended to address comments previously submitted that an absolute ban on principal transactions in fixed income securities, which are frequently sold by broker-dealers as principal or riskless principal, would be particularly problematic and such a ban would impose a substantial burden on municipal entities.[160] The MSRB believes the types of fixed income securities that are designated is responsive to commenters' concerns raised previously that the common industry practice of trading fixed income securities as principal or riskless principal would limit the access of municipal entities to such transactions.[161] The MSRB also notes that, in commenting that an exception to the ban for fixed income securities should be incorporated in Proposed Rule G-42, SIFMA did not specify any particular fixed income securities that it believed should be within an exception.

The MSRB understands that a municipal entity must have readily available options to invest in a variety of instruments, including money market instruments, with bond proceeds, and in making investment decisions, the municipal entity may desire to obtain advice from the provider. The MSRB believes, however, that municipal entities seeking to purchase or sell money market instruments and receive related advice would have sufficient access and flexibility to choose among various providers. As explained above regarding the context in which the issues regarding the Exception arise, the MSRB believes many investment scenarios will exist under which Proposed Rule G-42 and the ban will not apply at all. As another example, the SEC specifically exempted from the definition of municipal advisor any bank to the extent the bank provides advice with respect to, among other things: any investments that are held in a deposit account, savings accounts, certificate of deposit, or other deposit instrument issued by a bank, any funds held in a sweep account meeting certain requirements under the Exchange Act and any investment made by a bank acting in the capacity of an indenture trustee or similar capacity (e.g., a bond indenture trustee, paying agent, or municipal escrow agent).[162] Thus, although the proposed Exception does not include transactions in money market instruments, municipal entities will be able to consult with financial institutions to obtain access to such financial services and products and related advice. Moreover, the MSRB limited the fixed income securities for which the Exception is available to generally relatively liquid fixed income securities trading in relatively transparent markets, in order to raise significantly less risk

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160 See Amendment No. 2 Notice, 80 FR at 71860.

161 See SIFMA letter, dated September 11, 2015, at 6 ("Since nearly all transactions in fixed-income securities are effected on a principal basis, the problem [of not having any exception to the principal trading ban] is particularly acute with respect to that market – a fact explicitly recognized by the SEC.") (referring to the SEC's relief for broker-dealers engaging in principal transactions in certain fixed income securities pursuant to the IA Rule).

162 See Exchange Act Rule 15Ba1-1(d)(3)(iii); SEC Final Rule, 78 FR at 67533-35.

for municipal entity clients. With the exception of U.S. Treasury securities, the securities identified in the Exception are subject to mandated trade-by-trade transparency, whereas money market instruments are not. Virtually all transactions in such securities must be reported and the final transaction pricing is then immediately disseminated and accessible -- to industry participants by subscription and to the public free of charge on a website administered by FINRA. The MSRB believes that the transparency available in the market for the identified securities provides additional protections to municipal entity clients and is an important aspect of this new provision. Prior to implementing the Exception and reviewing its impact on the market, the MSRB does not believe it is appropriate to amend it to include this group of fixed income securities. Therefore, the MSRB, at this time, does not believe that proposed SM .14 and SM .15 should be modified to include money market instruments.

Broker-Dealer Affiliates of the Municipal Advisor

SIFMA commented that it was unclear whether the Exception would extend to the affiliates of a municipal advisor, and that there does not appear to be any reason to permit a municipal advisor (if also a broker-dealer) to benefit from the Exception, and not similarly allow an affiliate (if also a broker-dealer, or if exempt from registration as a broker-dealer) to benefit from the Exception.[163] SIFMA noted that multi-service financial institutions organize themselves in various ways to achieve their corporate objectives and, in SIFMA's view, making the Exception available to the affiliates of a municipal advisor would allow municipal entities to "maintain ongoing availability of securities transaction services."[164]

The MSRB believes it is clear from the language of proposed SM .14 that the use of the Exception to the principal transaction ban would be limited to the municipal advisor and would not extend to its affiliates. According to the procedural requirement in proposed SM .14 (d)(2)(B), for example, the municipal advisor must obtain from the municipal entity client a written, revocable consent prospectively authorizing the municipal advisor directly or indirectly to act as principal for its own account. In addition, according to the procedural requirement in proposed SM .14(d)(2)(C), prior to the execution of each principal transaction, the municipal advisor must inform the municipal entity client of the capacity in which the municipal advisor will act with respect to the transaction, and must obtain consent from the municipal entity client to act as principal for the municipal advisor's own account with respect to such transaction.

The MSRB continues to believe that this limited scope of the Exception is appropriate. The Exception was designed to provide municipal entities access to services from known financial intermediaries with whom they have a relationship, and

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163 See SIFMA letter, dated December 1, 2015.

164 Id.

simultaneously to address and mitigate certain conflicts of interest when a single entity would provide advice that constitutes municipal advisory activity to its municipal entity client and also engage in a principal transaction with such client. Moreover, when the proposed Exception is used by only a single entity, the application of the Exception is clearer, allowing the entity and regulatory authorities to determine if all terms and conditions of the Exception have been met, and the applicable provisions under the Exchange Act have been followed. Commenters, including SIFMA, generally urged the incorporation of an exception for broker-dealers that may be called upon by municipal entities to provide advice with respect to the broker-dealers transaction execution services.[165] The substantive and procedural safeguards are intended to address the conflicts within that single entity, and the MSRB does not believe at this time that the Exception should be broadened to include affiliates.

Compliance with Disclosure and Documentation Requirements

SIFMA, in response to Amendment No. 2, commented that it would be impractical for a firm relying on the Exception to comply with the conflicts disclosure and relationship documentation requirements of proposed sections (b) and (c), particularly on a transaction-by-transaction basis.[166] SIFMA stated that unless the issue is solved, brokerage firms that are municipal advisors will be effectively unable to provide the advice that municipal entity customers need and rely on, and municipal entities will need to take the costly and unnecessary step of having to engage separate investment advisers and brokers. GFOA asked why the disclosure of conflicts of interest and the municipal advisory relationship documentation required by sections (b) and (c) of Proposed Rule G-42, respectively, should apply to a firm selling investments of bond proceeds where the firm makes the disclosures and obtains the consents that would be required under proposed SM .14.

The MSRB believes that the duties and obligations of a municipal advisor under Proposed Rule G-42 regarding the disclosures of conflicts of interest and other information and municipal advisory relationship documentation should not be waived or diminished because a municipal advisor uses the Exception under proposed SM .14. First, the more weighty consideration in regard to proposed sections (b) and (c) is not that the firm may be complying with the requirements of the Exception, but that the firm is a municipal advisor with a fiduciary duty to the client. SIFMA "acknowledges that a person is a 'municipal

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165 See, e.g., SIFMA letter, dated September 11, 2015 ("In particular, a municipal entity or obligated person may call upon their broker-dealer for incidental investment advice in connection with the execution of many small investments, with the risk to the municipal entity flowing from any particular piece of advice being significantly less than that arising from advice in the issuance context.").

166 See SIFMA letter, dated December 1, 2015.

advisor' whether it advises a municipal entity on a large issuance of municipal securities or it provides brokerage with sporadic incidental advice on the investment of the proceeds of a previous issuance."[167]The ban, to which the Exception relates, only would apply in the case of clients that are municipal entities, meaning the disclosures and documentation at issue will always be in support of the fulfillment of a fiduciary duty.

Second, the proposed requirements under proposed sections (b) and (c) to provide disclosure of conflicts of interest and other information to a client and document the municipal advisory relationship, respectively, are separate and distinct requirements from the disclosures and consent conditions in proposed SM .14. In proposed section (b), the obligation of the municipal advisor to disclose generally would be substantially broader in scope than that required under either proposed SM .14(d)(1) or (2). Under proposed section (b), a municipal advisor must disclose in writing to the client all material conflicts of interest as well as information regarding 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. Similarly, under proposed section (c), the required documentation of the relationship is much broader in scope than the documentation that is a condition under either proposed SM .14(d)(1) or (2).

The MSRB believes that the requirements under the Exception, together with other provisions of Proposed Rule G-42, are sufficiently flexible to be complied with in a practical and cost-effective manner. First, although the requirements under the Exception and proposed sections (b) and (c) are distinct, to the extent content requirements overlap, no provision in Proposed Rule G-42 would preclude a municipal advisor from complying with multiple rule provisions in a single document, provided the document meets all of the requirements of the multiple provisions. Second, no provision in Proposed Rule G-42 would require in all circumstances that proposed sections (b) and (c) be complied with on a transaction-by-transaction basis. The Proposed Rule generally contemplates that a municipal advisor may establish a municipal advisory relationship for a sustained, and even indefinite, period. For example, such a sustained relationship could be established for the express purpose of periodically advising on the investment of proceeds of municipal securities, and the requirements in proposed sections (b) and (c) and the prospective written disclosure under proposed SM .14(d)(2)(b) could be accomplished at the same time in a single document, and updated only as required.

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167 See SIFMA letter, dated September 11, 2015.

II. OTHER COMMENTS

Standards of Conduct – Proposed Section (a)

Duty of Care - Reasonable Investigation of Facts

In response to Amendment No. 1 or the OIP, Columbia Capital, ICI, NAMA, SIFMA and WM Financial each expressed concerns regarding proposed SM .01, which would require a municipal advisor to make a reasonable investigation, with respect to information provided by the municipal advisor's client, to determine that the municipal advisor is not basing any recommendation on materially inaccurate or incomplete information.[168] In Columbia Capital's view, the proposed requirement is unreasonable because it would hold a municipal advisor accountable if a municipal entity or obligated person fails to provide the municipal advisor pertinent non-public information that might have impacted its advice or recommendations.[169] ICI noted its consistent support of Proposed Rule G-42, but reiterated its objection to the requirement that a municipal advisor conduct a reasonable investigation of the veracity of the information provided by a municipal advisory client. ICI stated its view that, to date, the MSRB has failed to provide any rationale, or "meaningful information" supporting the necessity of the requirement, or why such investigation is in the public interest. In addition, ICI stated that the MSRB has not provided sufficient economic analysis for this requirement.[170]

NAMA believed the Proposed Rule does not provide adequate guidance as to what a "reasonable investigation" would require of a municipal advisor. NAMA believed, without further clarity, examination for compliance with the Proposed Rule by financial regulators "could lead to unsettling results."[171] SIFMA commented that the proposed obligation is "unnecessary, counterproductive, and inefficient." In addition, SIFMA believed that the requirement would impose unnecessary costs on municipal advisor clients, who, in SIFMA's opinion, would ultimately bear the financial burden of having their municipal advisor investigate facts already known to the client.[172] ICI and SIFMA both pointed to other regulatory regimes and

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168 See letters from Columbia Capital, dated September 10, 2015; ICI, dated September 11, 2015; NAMA, dated September 11, 2015; SIFMA, dated September 11, 2015; and WM Financial, dated September 11, 2015.

169 See Columbia Capital letter, dated September 10, 2015.

170 See ICI letter, dated September 11, 2015.

171 See NAMA letter, dated September 11, 2015.

172 See SIFMA letter, dated September 11, 2015.

rules where, according to the commenters, regulated entities (e.g., broker-dealers, swap dealers and investment advisers) are not required to investigate information provided by clients.

WM Financial supported the requirement that a municipal advisor should conduct reasonable investigations of publicly available documentation and engage in discussions with the client such that the municipal advisor's recommendations reflect what the advisor reasonably believes is in the customer's best interest. However, WM Financial commented that a municipal advisor should not be required to determine whether the information provided to it by its client is materially inaccurate or incomplete, and should be able to rely on publicly available documents as being true and accurate.[173]

In response to Amendment No. 2, ICI reiterated the concerns regarding the Proposed Rule's requirement that municipal advisors undertake a reasonable investigation of the accuracy and completeness of information on which a municipal advisor bases its recommendation.[174] ICI stated that Amendment No. 2, despite the amendment stating otherwise, did not address its concerns regarding the "reasonable investigation requirement" and the MSRB should provide its basis for maintaining the requirement. As included in its previous comment letters addressing the "reasonable investigation" requirement, ICI again stated that the MSRB has not provided a sufficient economic analysis of the potential impact of the requirement and should be required to do so with special particularity for "advice rendered in connection with 529 college savings plans."[175]

As the MSRB has previously stated, the duty of care is a core principle underlying many of the obligations of the Proposed Rule.[176] Moreover, the MSRB believes the proposed requirement to conduct a reasonable investigation is vital because the veracity of the information on which a municipal advisor bases its recommendation can have a significant impact on the ability of a municipal advisor to make informed and suitable recommendations. The MSRB therefore believes the proposed requirement is necessary to promote the integrity of the municipal advisory relationship and protect clients from the potentially costly consequences of transactions undertaken based on unsuitable recommendations.

As the MSRB has previously stated, a municipal advisor would not be required to go to impractical lengths to determine the accuracy and completeness of the information on which it

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173 See WM Financial letter, dated September 11, 2015.

174 See ICI letter, dated December 1, 2015.

175 See id.

176 See Notice of Proposed Rule G-42, 80 FR at 26753, 26761, 26763, 26773-74 and 26784. See also MSRB Response at 8-9.

would be basing its advice and/or recommendation. Instead, a municipal advisor would be required to investigate using reasonable diligence. For example, if the information necessary to determine whether a municipal advisor is basing its recommendation on materially inaccurate or incomplete information is non-public, entirely created or controlled by the client or is otherwise not accessible through reasonable steps by the municipal advisor, then, in such instances, the determination of what would constitute a reasonable investigation would be reflective of those, and all other, relevant facts and circumstances.[177]

Further, the MSRB understands that municipal advisors currently, and regularly, follow an industry practice of conducting due diligence and fact finding inquiries that may, or, with some modest modifications, satisfy the requirement to undertake a "reasonable investigation." In such cases, the proposed requirement would add only nominal costs, if any. As the MSRB previously acknowledged, implementing the Proposed Rule may result in more substantial costs for those municipal advisors that do not currently take any steps to verify the accuracy and completeness of the information on which they base their advice.[178] Notwithstanding, as the proposed requirement requires the undertaking of a "reasonable investigation," the MSRB continues to believe that the requirement is appropriate.

Duty of Care - Preparing Official Statements

In response to Amendment No. 1 or the OIP, SIFMA commented that proposed SM .01 should more explicitly state that municipal advisors assisting in the preparation of any portion of an official statement in connection with a competitive transaction must exercise "reasonable diligence with respect to the accuracy and completeness of any portion of the official statement as to which the municipal advisor assisted in the preparation."[179] SIFMA stated that while the Proposed Rule does include a reference to this requirement, the rule language should more explicitly clarify this obligation.

The MSRB certainly agrees with SIFMA regarding the importance of the accuracy of information contained in an official statement. Where a municipal advisor participates in the preparation of a portion of the official statement, SM .01 would specifically require a municipal advisor to have a reasonable basis for "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 municipal advisor is advising." Also, the MSRB previously has stated that,

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177 Id.

178 See Notice of Proposed Rule G-42, 80 FR at 26759-60, 26763, 26773-74 and 26784-85. See also MSRB Response at 8-9.

179 See SIFMA letter, dated September 11, 2015.

> [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.[180]

The MSRB believes that the rule language, as proposed, is sufficient to alert municipal advisors of their obligation and that the rule language conveys the importance of exercising due care when providing information or advice in connection with the preparation of an official statement.

Disclosure of Material Conflicts of Interest – Proposed Section (b)

Timing of Providing Disclosures to Client

In support of the Proposed Rule and in response to Amendment No. 1 or the OIP, NAMA stated that the changes the MSRB made to proposed sections (b) and (c) subsequent to the First and Second Requests for Comment were "helpful to both [municipal advisors] and to the marketplace in general."[181] Columbia Capital commented that it supports the requirement in proposed section (b) that a municipal advisor disclose material conflicts of interest prior to or upon engaging in municipal advisory activities.[182] However, Columbia Capital suggested modifying the rule language to state that a municipal advisor must provide such disclosures "at any time requested by the municipal entity or obligated person, but not later than engaging in" municipal advisory activities.[183] Columbia Capital believed this would provide more clarity

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180 See Notice of Proposed Rule G-42, 80 FR at 26753.

181 Specifically, NAMA referenced the changes made to the "[t]iming of [e]videncing a [m]unicipal [a]dvisory [r]elationship," which is a subject addressed in proposed section (c) (Documentation of Municipal Advisory Relationship) and "conflicts disclosure," which is addressed in proposed section (b) (Disclosure of Conflicts of Interest and Other Information) and proposed subsection (c)(ii). See NAMA letter, dated September 11, 2015.

182 See Columbia Capital letter, dated September 10, 2015. Proposed section (b) would require a municipal advisor to, "prior to or upon engaging in municipal advisory activities, provide to the municipal entity or obligated person client full and fair disclosure . . . ." (emphasis added).

183 See id.

regarding the requirement, without changing the substance, and thereby promote better compliance with the proposed section.

After carefully considering Columbia Capital's suggestion, the MSRB believes that the suggested language would not necessarily provide more clarity to municipal advisors or better aide in compliance with the proposed requirement than the current rule language. The MSRB believes that it would be desirable to maintain the proposed rule language of section (b) because it more clearly coordinates with the language in proposed section (c)[184] regarding the documentation of the municipal advisory relationship and would, therefore, better assist municipal advisors in complying with the different timing requirements of both sections. Further, section (b) contemplates that disclosures may be made at any time prior to engaging in municipal advisory activities, and therefore nothing in the Proposed Rule would prevent a municipal advisor and its client from agreeing that the disclosures would be made when requested by the client, so long as the disclosures are made in compliance with all of the terms of proposed section (b) and other applicable rules.

Contingent Fee Arrangements

In response to Amendment No. 1 or the OIP, Columbia Capital and WM Financial expressed concern with the MSRB's retention of the requirement in proposed paragraph (b)(i)(F) that municipal advisors disclose "any conflict 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 . . . ." Columbia Capital commented that every type of fee structure "creates a set of incentives and disincentives that can be detrimental to the municipal entity or obligated person," and specifying contingent compensation arrangements in the Proposed Rule implies that contingent compensation arrangements are more problematic or imbued with greater conflicts of interest than other compensation arrangements.[185] Columbia Capital suggested that the Proposed Rule be modified to require municipal advisors to disclose how they are compensated and to discuss incentives and disincentives that result from such compensation arrangements and structures. WM Financial commented that contingent fee arrangements do not give rise to material conflicts of interest requiring disclosure in every case, and disclosure should not be required of contingent fee arrangements that do not inherently create conflicts of interest. WM Financial believed that such arrangements also serve a useful and beneficial function for municipal entity clients (e.g., for

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184 Proposed section (c) would require a 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." (emphasis added).

185 See Columbia Capital letter, dated September 10, 2015.

clients with relatively small budgets) in that "governmental funds will not be drawn upon for payment of fees if the transaction is not completed."[186]

Substantially similar comments to those set forth above were previously made and carefully considered,[187] and the MSRB has carefully reconsidered these comments. As previously stated, the MSRB believes that requiring municipal advisors to disclose conflicts of interest that could arise from, or are inherent in, contingent compensation is an appropriate and necessary measure to protect municipal entity and obligated person clients. The MSRB notes that, in connection with underwriters, the MSRB requires analogous disclosures in an analogous context. Pursuant to Rule G-17, the MSRB requires a dealer acting as an underwriter to disclose to an issuer whether its underwriting compensation will be "contingent on the closing of a transaction or the size of a transaction," because, as the MSRB has stated, such circumstances may present a conflict of interest as a result of the underwriter's financial incentive to recommend a transaction that is "unnecessary or to recommend that the size of the transaction be larger than is necessary."[188] The MSRB believes that the scenarios in which proposed paragraph (b)(i)(E) would apply are substantially similar, are subject to the same concerns, and warrant the application of similar disclosure requirements to help make transparent potential conflicts of interest. The purpose of the disclosure requirement,[189] is, of course, to allow a municipal advisor's client to make an informed decision based on relevant facts and circumstances, and, as the MSRB previously explained, 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 it understands, with which it is comfortable, and that serves its needs. The MSRB does not disagree that other fee arrangements also may give rise to conflicts, and notes that other terms of proposed section (b) require broad disclosure of all actual and potential material conflicts of interest. In addition, as the MSRB has emphasized, it does not endorse, nor discourage, the use of any particular lawful compensation arrangement.[190]

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186 See WM Financial letter, dated September 11, 2015.

187 See letters from Lewis Young, dated March 3, 2014, and Cooperman, dated March 10, 2014, in response to the First Request for Comment, and letters from Columbia Capital, dated August 25, 2014, and Piper Jaffray, dated August 25, 2014, in response to the Second Request for Comment. See also Notice of Proposed Rule G-42, 80 FR at 26764-65.

188 See Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities, dated August 2, 2012.

189 See Notice of Proposed Rule G-42, 80 FR at 26764-65. See also MSRB Response at 4-5.

190 See Notice of Proposed Rule G-42, 80 FR at 26764-65. See also MSRB Response at 5.

Notification Regarding Changes to Forms MA and MA-I – Proposed Subsection (c)(iv)

Amendment No. 1 revised Proposed Rule G-42(c)(iv) to require a municipal advisor, at the time of making a disclosure of the date of the last material change or addition to the legal or disciplinary event disclosures on any Form MA or Form MA-I filed with the Commission, to also provide a brief explanation of the basis for the materiality of each change or addition.[191] In response to Amendment No. 1 or the OIP, SIFMA objected to proposed subsection (c)(iv) and the recent amendment and believed that the proposed rule change would be "unnecessary and overly burdensome, outweighing any potential benefit."[192] SIFMA agreed that municipal advisory clients should have access to information regarding a municipal entity's legal and disciplinary events, and that clients should receive notifications of material new disclosures. However, in SIFMA's view, the additional requirement would not create any benefit for a municipal advisor's client and would result in "additional paperwork burdens" for the municipal advisor. SIFMA added that Form MA and MA-I disclosures, in a manner similar to SEC Forms BD and ADV and the Financial Industry Regulatory Authority ("FINRA") Form U4, already require an explanation of the events that would also be required to be disclosed and explained under proposed subsection (c)(iv).

The MSRB believes that requiring a municipal advisor to provide a brief explanation of the basis for the materiality of each change or addition would allow a municipal entity client to assess the effect that such changes may have on the municipal advisory relationship and evaluate whether it should seek or review additional information. When developing this amendment, the MSRB gave due consideration to comments submitted by GFOA suggesting changes to the information disclosures that GFOA believed would allow issuers to focus more efficiently on disclosures that would be material to them and affect them directly.[193]

Recommendations – Proposed Section (d)

Definition of "Recommendation"

In response to Amendment No. 1 or the OIP, SIFMA expressed concern regarding Proposed Rule G-42(d), which would require, among other things, a municipal advisor making a recommendation, or reviewing the recommendation of another party at the request of its client, to have a reasonable basis to believe that the recommended municipal securities transaction or

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191 The amendment to Proposed Rule G-42(c)(iv) is set forth more specifically in Amendment No. 1.

192 See SIFMA letter, dated September 11, 2015.

193 See GFOA letter, dated June 15, 2015.

municipal financial product is, or (as may be applicable in the case of a review of another party's recommendation) is not, suitable for its client.[194] Specifically, SIFMA commented that it is unclear when a communication constitutes a "recommendation" (thus triggering a suitability analysis under the proposed rule change), as opposed to "advice" or, as SIFMA referenced, "ancillary advice." According to SIFMA's comment, in order to "design effective policies and procedures, and to evidence compliance with this obligation" municipal advisors need to be certain of when their suitability obligation applies.[195] In SIFMA's view, because of the uncertainty created by the Proposed Rule regarding "what is a recommendation versus what is ancillary advice," FINRA and SEC examiners also would need additional guidance to properly examine for compliance with the rule.[196]

As the MSRB previously stated in response to similar comments, the Proposed Rule 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.[197] In conformance with that interpretive guidance, the MSRB has stated that 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 would obligate the municipal advisor to conduct a suitability analysis of its recommendation that adheres to the requirement established by the Proposed Rule. The MSRB previously has stated that, depending on all of the facts and circumstances, communications by a municipal advisor to a client 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 change) but would not trigger the suitability obligation set forth in proposed section (d).[198] The MSRB believes that providing a more prescriptive definition of the term "recommendation" is unnecessary and that the Proposed Rule, along with the related and referenced interpretive guidance that has been in place for dealers for over a decade, will provide municipal advisors, and SEC and FINRA examiners with sufficient guidance on this subject.

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194 See SIFMA letter, dated September 11, 2015.

195 See id.

196 See id.

197 See Notice of Proposed Rule G-42, 80 FR at 26756 n. 18 (citing MSRB Rule G-19 and MSRB Notice 2002-30 (September 25, 2002), Notice Regarding Application of Rule G-19, on Suitability of Recommendations and Transactions, to Online Communications).

198 See id.

Suitability Determinations

In support of the Proposed Rule and in response to Amendment No. 1 or the OIP, NAMA commented that the changes the MSRB made during the development of the Proposed Rule regarding, among other things, recommendations and the review of recommendations of other parties, were helpful to municipal advisors and the marketplace in general.[199] NAMA also commented, however, that the Proposed Rule needed additional clarification "of the manner in which a [municipal advisor] must perform reasonable due diligence to determine suitability . . . ." NAMA suggested that clarification could be provided in the form of additional or augmented supplementary material, interpretive guidance and/or, presumably in either the Proposed Rule or interpretive guidance, a non-exhaustive list of examples of practices that a municipal advisor could adopt to comply with the proposed rule change.

As previously noted, the MSRB has developed the Proposed Rule to accommodate the diverse nature of the municipal securities and municipal advisory marketplace. As such, the MSRB has determined to take a primarily principles-based approach regarding suitability determinations.[200] The MSRB believes that this approach will promote municipal entity and obligated person clients' receipt of appropriately tailored and relevant advice and recommendations from their municipal advisors. The MSRB has carefully crafted proposed subsections (d)(i)-(iii) and proposed SM .01, SM .09 and SM .10 to include guidance regarding what information a municipal advisor could, or must, consider when forming and providing advice or recommendations to its clients. The MSRB believes that incorporating a more prescriptive, or more descriptive approach, as suggested by some commenters, to determining suitability would risk creating inflexible requirements that would fail to adequately account for the diversity of municipal advisors, the municipal advisory activities in which they engage and the varying needs of their clients. The MSRB believes that providing a non-exhaustive list of examples of how a municipal advisor could comply with the Proposed Rule, as suggested by NAMA, would also risk creating the potentially costly and rigid requirements that the Proposed Rule is intended, and designed, to avoid. As the Proposed Rule has yet to be implemented and there is no observable indicia that municipal advisors would not be able to comply with the requirements of the Proposed Rule regarding suitability determinations without incurring significant costs and bearing unreasonable burdens, the MSRB has determined not to provide additional interpretive guidance or make amendments to the rule language at this time.

Consideration of Alternatives to Recommended Transaction or Product

In response to Amendment No. 1 or the OIP, NAMA requested additional clarification regarding proposed section (d)(iii), which would require a municipal advisor to inform its client

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199 See NAMA letter, dated September 11, 2015.

200 See Notice of Proposed Rule G-42, 80 FR at 26771.

of "whether [it] 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."[201] NAMA believed that the proposed language created greater ambiguity surrounding the requirements of this section, and in particular the documentation requirements associated with compliance.

As the MSRB has previously stated, proposed section (d), like other provisions of Proposed Rule G-42, would reflect the basic principle that the client should control the scope of the engagement with its municipal advisor (with the agreement of the municipal advisor) so long as such agreement does not alter the standards of conduct or duties imposed by the Proposed Rule with respect to that limited scope.[202] Consistent with this principle, proposed subsection (d)(iii) would require a municipal advisor to inform its client whether or not it considered other reasonably feasible alternatives to the recommendation it made to its client that might also or alternatively serve the client's objectives. This subsection leaves to the arrangement between the municipal advisor and its client whether such alternatives would be communicated or presented to the client. The MSRB reiterates its previous statement that the proposed provision would not require a municipal advisor to provide its client with an exhaustive list of "alternative financings" together with its recommendation (particularly if such alternative financings are not germane to the client).[203] The MSRB reiterates that proposed subsection (d)(iii), and all other provisions of the Proposed Rule, would not require a municipal advisor to conduct a suitability analysis on any "reasonably feasible alternative" considered or investigated by the municipal advisor if such activity is not an agreed-upon part of the municipal advisory engagement. The municipal advisor would be obligated under proposed subsection (d)(iii) only to inform its clients whether or not it considered or investigated reasonably feasible alternatives. The MSRB believes that proposed subsection (d)(iii) would effectively convey the nature and scope of a municipal advisor's obligations with respect to this matter and, therefore, has determined not to modify the proposed section at this time as suggested.

Recordkeeping Related to Recommendations – Proposed Rule G-8(h)(iv)

In response to Amendment No. 1 or the OIP, BDA, Columbia Capital, NAMA and SIFMA expressed concern over the documentation requirement under proposed Rule G-8(h)(iv), which would require a municipal advisor to 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

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201 See NAMA letter, dated September 11, 2015.

202 See Notice of Proposed Rule G-42, 80 FR at 26756.

203 See MSRB Response at 8.

memorializes the basis for any determination as to suitability."[204] BDA, Columbia Capital and SIFMA expressed concern about the examination of municipal advisors by financial regulators (such as the SEC and FINRA), including the question of how the regulators would determine whether a municipal advisor had complied with the proposed requirements related to recommendations and documentation retention. The commenters stated that the Proposed Rule should provide additional guidance on the documentation to be maintained. BDA stated that a transaction on which a municipal advisor is advising may take place over the course of years, and that it would be difficult for a municipal advisor to have a financial regulatory examiner come in after the completion of a transaction and examine the municipal advisor's documentation process. BDA noted that "it just takes one element of omission to find a firm at fault."[205] Finally, BDA commented that, without additional guidance about how a municipal advisor would comply with the proposed provisions addressing recommendations, a discrepancy may occur between information the examiner desired to review and that which the municipal advisor could provide.

Columbia Capital commented that it would be very difficult for a municipal advisor to "document the rationale for every point of advice in a municipal advisory relationship, including documenting the rationale for every conceivable path not taken."[206] Columbia Capital stated that, without additional specificity, a municipal advisor's recommendation could be subject to unreasonable scrutiny by examiners that would not adequately take into account the totality of the circumstances that impacted the formation of the recommendation provided by the municipal advisor. SIFMA also commented that it is unclear as to what documentation should be maintained to "demonstrate in a regulatory examination" that which the municipal advisor relied upon in making a suitability determination.

In addition, Columbia Capital stated its belief that the recordkeeping requirements "might actually conflict with [a firm's] fiduciary duty where [the] client desires to maintain such internal dialogue in confidence" but where the client (in particular public clients) is subject to open records laws that may frustrate that desire.[207] NAMA stated that the Proposed Rule is unclear as to whether the document requirements apply to the financing "as a whole" or whether they apply to "every facet of a transaction" which could span several months. SIFMA stated that the proposed documentation requirement is "vastly more burdensome" than the documentation requirement currently applicable to investment advisers.

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204 See letters from BDA, dated September 11, 2015; Columbia Capital, dated September 10, 2015; NAMA, dated September 11, 2015; and SIFMA, dated September 11, 2015.

205 See BDA letter, dated September 11, 2015.

206 See Columbia Capital letter, dated September 11, 2015.

207 See id.

As discussed in the initial filing of the proposed rule change,[208] the MSRB believes that 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 Proposed Rule G-42. The MSRB believes the recordkeeping requirement will not be overly burdensome because municipal advisors would be required to maintain only the documents created by the municipal advisor that: (a) were material to its review of a recommendation by another party or (b) memorialize the basis for any conclusions as to suitability of a recommendation the municipal advisor provided. By limiting the proposed recordkeeping requirement to documents that were material to the review of a recommendation or that memorialize the basis for a suitability determination as to a recommendation, the MSRB does not believe that the Proposed Rule would require, as suggested by Columbia Capital, a municipal advisor "to document the rationale for every point of advice" and "the rationale for every conceivable path not taken." Further, in the initial proposed rule change, the MSRB discussed communications between municipal advisors and their clients, noting that certain communications would constitute recommendations of a municipal securities transaction or municipal financial product and others, advice. [209] Only the

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208 See Notice of Proposed Rule G-42, 80 FR at 26773.

209 As the MSRB stated in the Notice of Proposed Rule G-42:

> 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. 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).

80 FR at 26756; see id. at 26756 n.18 (citing to MSRB Rule G-19 and MSRB Notice 2002-30 (September 25, 2002), Notice Regarding Application of Rule G-19, on Suitability of Recommendations and Transactions, to Online Communications, as sources of some general principles and existing interpretations to consider to analyze whether a

former triggers a suitability determination under the Proposed Rule. Therefore, if a municipal advisor's communication with its municipal entity or obligated person client is advice but not a recommendation, the proposed documentation requirement would not apply.

With regard to Columbia Capital's concerns about a municipal advisor maintaining a level of confidentiality as may be requested by a client, the MSRB believes the Proposed Rule would not create the conflict discussed because proposed Rule G-8(h)(iv) would not require a municipal advisor to deliver documents that must be maintained by the municipal advisor to the client or into the possession of a party not privy to, or contemplated under, the municipal advisory relationship. Under Proposed Rule G-42(d), a municipal advisor would be required to "inform" its client, in a manner that comports with its duty of care and the expressed terms of its agreement with its client, of certain aspects of its recommendations,[210] and, the municipal advisor and its client would have some discretion as to the manner in which that information is provided. The MSRB believes that the discretion provided for in the Proposed Rule will allow a municipal advisor to reasonably accommodate a request by a municipal advisory client such as that described by Columbia Capital and also comply with its fiduciary obligations.

Inadvertent Advice – Proposed SM .07

In response to Amendment No. 1 or the OIP, Columbia Capital expressed concern regarding proposed SM .07, which addresses the subject of inadvertent advice. Columbia Capital commented that proposed SM .07 is "rife for abuse" and that the MSRB should define "inadvertent" very narrowly.[211]

As the MSRB previously noted, proposed SM .07 would only apply when a municipal advisor inadvertently engages in municipal advisory activities but does not intend to continue the

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particular communication by a municipal advisor constitutes a recommendation of a municipal securities transaction or municipal financial product).

210 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.

211 See Columbia Capital letter, dated September 10, 2015.

municipal advisory activities or enter into a municipal advisory relationship.[212] Moreover, the proposed paragraph would only relieve the municipal advisor from complying with proposed sections (b) and (c) (relating to disclosure of conflicts of interest and documentation of the relationship) of Proposed Rule G-42, and not any other requirements. In addition, the limited relief that would be afforded by proposed SM .07 would only be granted if the municipal advisor provided to the client, promptly after it discovers its provision of inadvertent advice, the information enumerated in proposed SM .07. In addition, to perfect the relief granted by proposed SM .07, the municipal advisor would be required to conduct a review of its supervisory and compliance policies and procedures to ensure that they are reasonably designed to prevent the municipal advisor from inadvertently providing advice to municipal entities and obligated persons. The terms of proposed SM .07 make clear that municipal advisors using the limited safe harbor would have no effect on the applicability of any provisions of Proposed Rule G-42 other than proposed 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, FINRA rules or federal or state laws that apply to municipal advisory activities. The MSRB believes that proposed SM .07 is sufficiently clear with regard to the narrow relief it allows and that the obligations that municipal advisors would be required to undertake to obtain that relief are adequate to curb the types of abuse about which commenters have expressed concern.

Relationship between the Ban, Rule G-23 and the Inadvertent Advice Exemption

NAMA and WM Financial commented regarding proposed SM .08 referring to the relationship between MSRB Rule G-23 (Activities of Financial Advisors) and Proposed Rule G-42, including the prohibition on certain principal transactions in proposed subsection (e)(ii). The final sentence of proposed SM .08 states that the prohibition in proposed 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 that is a type of transaction that is addressed and prohibited in certain circumstances by Rule G-23." NAMA commented that the reference to Rule G-23 should be deleted from proposed SM .08. In NAMA's view, the MSRB's statements regarding this provision are unnecessarily complicated. In addition, in NAMA's view, such statements raise a question that the MSRB may believe that conduct permitted by MSRB Rule G-23 would be otherwise prohibited by proposed Rule G-42 (apart from proposed Rule G-42(e)(ii)). WM Financial commented that proposed SM .07 on inadvertent advice would create "a loophole" that would allow broker-dealers to act in an advisory capacity, but without a fiduciary duty, then claim the advice was inadvertent and switch to the role of an underwriter, negating Rule G-23. WM Financial further indicated that the Proposed Rule blurs the line between financial advisors and underwriters, and undermines the definition of municipal advisor. WM Financial suggested that any entity relying on proposed SM .08 should be required to file

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212 See Notice of Proposed Rule G-42, 80 FR at 26754.

the required documentation not only with the issuer, but also with the MSRB, and that the filing should be made public. In addition, WM Financial suggested that any entity relying on proposed SM .07 be allowed to rely on the exception only one time in any calendar year.

As previously stated, the effect of the final sentence in proposed SM .08 is intentionally quite limited.[213] As to a person acting in compliance with Rule G-23, the final sentence in proposed SM .08 provides an exception, but only to the specific prohibition on principal transactions in Proposed Rule G-42(e)(ii). Proposed subsection (e)(ii) would not prohibit a type of principal transaction that is already addressed and prohibited, to a certain extent, under Rule G-23, although other provisions of Rule G-42 must be considered as they do apply to the same principal transaction. Stated another way, where certain conduct is not prohibited under Rule G-23 (as an exception to the general prohibition therein), Proposed Rule G-42(e)(ii) (the principal transaction provision) alone would not prohibit such conduct. Nevertheless, other parts of Proposed Rule G-42 and statutory provisions must be considered to determine whether the conduct, although not prohibited by Rule G-23 and not specifically prohibited under Proposed Rule G-42(e)(ii), would violate another provision of Proposed Rule G-42 or other applicable MSRB rules or other applicable laws or regulations.[214] In this respect, the type of principal transaction excepted by the final sentence of SM .08 from Proposed Rule G-42(e)(ii) is no different than any other principal transaction that is not specifically prohibited by subsection (e)(ii). As noted above, and as the MSRB has emphasized, merely because a principal transaction is not specifically prohibited by the principal transaction ban does not necessarily mean it is permitted. In response to WM Financial's concerns, the MSRB again notes that, as discussed above, proposed SM .07, on inadvertent advice, would only relieve the municipal advisor from complying with proposed sections (b) and (c) (relating to disclosure of conflicts of interest and documentation of the relationship) of Proposed Rule G-42, and not any other requirements. Therefore, SM .07 could not be used to avoid the application of the fiduciary duty when a municipal advisor has provided inadvertent advice to a municipal entity client.

Prospective Application of the Proposed Rule Change

In response to Amendment No. 1 or the OIP, ICI reiterated its comment that the Proposed Rule should only apply prospectively when a municipal advisor either enters into a new advisory relationship with a municipal client or when it recommends a new municipal securities transaction or new municipal financial product to an existing municipal client.[215] ICI indicated its appreciation of certain clarifications provided by the MSRB in the MSRB Response, but recommended that the MSRB further clarify "how each of the new obligations the rule and its

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213 See Notice of Proposed Rule G-42, 80 FR at 26757, 26781-83; MSRB Response at 21.

214 See Notice of Proposed Rule G-42, 80 FR at 26782-83. See also MSRB Response at 21.

215 See Notice of Proposed Rule G-42, 80 FR at 26769 (discussion of comments regarding the prospective application of the Proposed Rule).

Supplementary Material impose on municipal advisors will apply to existing contracts, relationships, and municipal advisory activities."[216] ICI stated that additional clarification of whether each section of Proposed Rule G-42 will apply prospectively or retroactively will "better facilitate the compliance efforts of municipal advisors."[217]

All provisions of the Proposed Rule would, if approved, apply only prospectively. As previously stated by the MSRB, the requirements of the Proposed Rule, including its Supplementary Material, would apply prospectively to any activity that is within the definition in the Proposed Rule of "municipal advisory activities" if that activity is engaged in on or after the date of implementation (the "effective date") of Rule G-42.[218] In addition, the Proposed Rule will apply to all municipal advisory relationships that are in existence on or after the effective date, regardless of when a municipal advisor and client may have entered into a particular relationship.[219] Because the making of recommendations and review of recommendations under proposed section (d) are defined "municipal advisory activities," the relevant requirements of the Proposed Rule, including the related Supplementary Material, apply to the making of any recommendation and review of any recommendation occurring on or after the effective date.[220] Note that upon the proposed rule change taking effect, municipal advisors will become subject to the applicable standards of conduct (e.g., Proposed Rule G-42's specified duty of care and duty of loyalty) with regard to all of their municipal advisory activities that are engaged in on or after

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216 See ICI letter, dated September 11, 2015.

217 See id. ICI stated that, as an example, proposed sections (b), (c) and (d) of the proposed rule change "would not appear to apply retroactively" while proposed SM .05 and SM .06 would appear to apply to municipal advisory relationships in place as of the effective date of the Proposed Rule.

218 The MSRB requested that the SEC approve the proposed rule change with an implementation date of six months after SEC approval of all changes. See Notice of Proposed Rule G-42, 80 FR at 26752.

219 See Notice of Proposed Rule G-42, 80 FR at 26769. See also MSRB Response at 22-23 (referring to the prospective application of the proposed rule change, the MSRB stated that municipal advisors would be required to conform to the disclosure and documentation requirements of proposed sections (b) and (c) for all municipal advisory relationships in place as of the effective date of the proposed rule change, and stated that proposed section (d) would apply to recommendations or reviews of recommendations made after the Proposed Rule becomes effective).

220 See MSRB Response at 23.

the effective date.[221] Importantly, in accordance with MSRB Rule G-44 (Supervisory and Compliance Obligations of Municipal Advisors), which is currently in effect, on the effective date of Rule G-42, if approved, each municipal advisor would be required to have established written supervisory procedures reasonably designed to ensure that the municipal advisor and its associated persons are in compliance with Rule G-42 on and after its effective date.

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The MSRB believes that Proposed Rule G-42, which is designed to establish the core standards of conduct for and duties of municipal advisors, will represent another significant milestone in the development of a comprehensive regulatory framework for municipal advisors and will further the MSRB's mandate to protect municipal entities, obligated persons, investors and the public interest.

If you have any questions, please feel free to contact me, Sharon Zackula, Associate General Counsel, or Benjamin Tecmire, Counsel II at (202) 838-1500.

Sincerely,

Michael L. Post
General Counsel – Regulatory Affairs

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221 Although the Proposed Rule would apply prospectively to municipal advisory activities, currently, municipal advisors are required, under MSRB Rule G-17, to deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice, and have been subject to a statutory fiduciary duty with respect to their municipal entity clients under the Dodd-Frank Act since 2010.