



## What to Expect from Your Municipal Advisor

Many state and local governments and other municipal securities issuers choose to hire a municipal advisor. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, municipal entities are now protected by a set of rules established for municipal advisors by the Municipal Securities Rulemaking Board (MSRB). The MSRB's jurisdiction was expanded to include the regulation of municipal advisors that provide advice to municipal entities.

In addition to other rules, as of June 23, 2016, municipal advisors are required to follow certain standards of conduct when engaging with their municipal entity clients. The MSRB believes that these standards will empower municipal entities and obligated persons in their relationships with their municipal advisors. MSRB Rule G-42 on Duties of Non-Solicitor Municipal Advisors (Rule G-42) establishes standards of conduct for municipal advisors engaging in municipal advisory activities, other than municipal advisory solicitation activities.

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This document provides only a brief overview of MSRB Rule G-42. Issuers should refer to the text of Rule G-42, MSRB Notice 2016-03 (January 13, 2016) and related materials on the MSRB's website for more information on the rule, other MSRB rules and rulemaking initiatives, and additional educational materials.



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Rule G-42 also establishes requirements for many aspects of the relationship between you, as the client, and your municipal advisor by addressing the disclosure of conflicts of interest, documentation of the relationship, recommendations and conduct that is specifically prohibited. When a municipal advisor's client is a state or local government or another governmental entity to which the municipal advisor owes a duty of loyalty, Rule G-42 also prohibits the municipal advisor and its affiliates from engaging in certain principal transactions with the client. Municipal entities and conduit borrowers that choose to retain a municipal advisor should be aware of the protections provided under Rule G-42.

## Considerations

Rule G-42 establishes core standards of conduct for municipal advisors engaging in municipal advisory activities, with the exception of municipal advisory solicitation activities.

### Duty of Care

When performing municipal advisory activities for a municipal entity client or an obligated person client, a municipal advisor must act in accordance with a duty of care. For example, a municipal advisor acting with a duty of care must:

- Possess the degree of knowledge and expertise needed to provide a client informed advice;
- Make a reasonable inquiry as to the facts that are relevant to a client's determination as to whether to proceed with a course of action, such as the issuance of securities, or the timing and particular instruments to be used in the investment of bond proceeds;
- Make a reasonable inquiry as to the facts that form the basis for any advice the municipal advisor provides to a client, such as facts that a municipal advisor might obtain from an expert or consultant hired by the client to provide advice on a potential issuance of securities to be paid by a specified revenue stream; and
- Have a reasonable basis for any advice provided to a client.<sup>1</sup>

### Duty of Loyalty

A municipal advisor that advises a municipal entity regarding the issuance of municipal securities or municipal financial products is a fiduciary to its municipal entity client. As such, the municipal advisor is subject to a duty of loyalty. The duty of loyalty requires a municipal advisor to deal honestly and with the utmost good faith and act in the client's best interests without regard to the financial or other interests of the municipal advisor.

In addition, the municipal advisor may not engage in municipal advisory activities for or on behalf of a municipal entity client if the municipal advisor cannot manage or mitigate its conflicts of interest in a manner that will permit it to act in the municipal entity client's best interests.<sup>2</sup> A municipal entity or an obligated person client may agree with its municipal advisor to limit the scope of the municipal advisory activities the municipal advisor will perform, specifying the particular services or activities to be provided by the municipal advisor. However, a municipal advisor cannot alter the duties it owes to its clients under the duty of care, and if applicable, the duty of loyalty.<sup>3</sup>

Municipal advisors are also subject to other duties and obligations under state and federal laws, and other MSRB rules. For example, under state or other federal laws, your municipal advisor may be subject to fiduciary or other duties. Rule G-42 does not supersede such provisions. Under MSRB Rule G-17, a municipal advisor is subject to a duty of fair dealing and is prohibited in the conduct of its municipal advisory activities from engaging in any deceptive, dishonest or unfair practice.

### Disclosure of Conflicts of Interest and Other Information

Knowing that your municipal advisor is required to disclose material conflicts of interest to you is one of the most important protections you have in evaluating whether the municipal advisor is an appropriate advisor for you. Rule G-42 requires a municipal advisor to make full and fair disclosure, in writing, of all material conflicts of interest and all legal and disciplinary events that are material to a client's evaluation of a municipal advisor, including the integrity of its management and advisory personnel. The disclosures must be provided

to you by the municipal advisor prior to or upon engaging in municipal advisory activities for you or on your behalf.

Regarding conflicts of interest, a municipal advisor must disclose:

- Any affiliate of the municipal advisor that provides any advice, service or product to or on behalf of the client that is directly related to the municipal advisory activities to be performed by the disclosing municipal advisor;
- Any payments made by the municipal advisor, directly or indirectly, to obtain or retain an engagement to perform municipal advisory activities for the client;
- Any payments received by the municipal advisor from a third party to enlist the municipal advisor's recommendation to the client of its services, any municipal securities transaction or any municipal financial product;
- Any fee-splitting arrangements involving the municipal advisor and any provider of investments or services to the client;
- Any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction as to which the municipal advisor is providing advice; and
- Any other actual or potential conflicts of interest, which a municipal advisor is aware of after reasonable inquiry, that could reasonably be anticipated to impair the municipal advisor's ability to provide advice in accordance with the standards established by the rule.

If, after reasonable diligence, a municipal advisor determines that it has no known material conflicts of interest to disclose, the municipal advisor must notify the client of this determination in writing.

A municipal advisor must also disclose 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. Provisions in Rule G-42 facilitate the use of existing public records to make the disclosures regarding these legal and disciplinary events to you in a cost-effective manner.

Make sure your municipal advisor provides you the disclosures in writing and in a manner designed to make clear the subject matter of the disclosures and their implications. To further protect a municipal advisor's client, the disclosures must include an explanation of how the municipal advisor addresses, or intends to manage or mitigate, each conflict.<sup>4</sup>

## Documentation of the Municipal Advisory Relationship

Rule G-42 requires your municipal advisor to document its municipal advisory relationship with you in writing, and the documentation must be dated and delivered to you prior to, upon or promptly after you and your municipal advisor establish your municipal advisory relationship. This ensures that both you and the municipal advisor have clear expectations about the activities to be performed.

The documentation must include certain information and aspects of the relationship:

- The scope of municipal advisory activities to be performed;
- Disclosures of conflicts of interest and legal and disciplinary events of the same scope as described above in "Disclosure to You of Conflicts of Interest and Other Information;"
- A description of specific types of information regarding legal and disciplinary events requested by SEC Forms MA and MA-I, detailed information specifying where the client may electronically access the most recent SEC forms, the date of the last material change or addition to the legal and disciplinary events disclosures on the SEC forms, and a brief explanation of the materiality of the amended portion of the SEC form;
- Limitations, if any, on the scope of the engagement; and
- The date, triggering event or other means providing for the termination of the municipal advisory relationship.

Rule G-42 does not require that the relationship documentation be a formal contract. For example, if state law provides for the procurement of municipal advisory services in a manner that does not require written documentation that is sufficient to establish a formal contract, your municipal advisor may send you

a written document that references the procurement document and contains the terms and disclosures required by Rule G-42, to document its municipal advisory relationship with you.

After the relationship is documented, your municipal advisor must update the documentation to reflect any material changes or additions to the information (e.g., update to add a new material conflict of interest).<sup>5</sup>

## Inadvertent Advice

If a person inadvertently engages in municipal advisory activities for you or on your behalf but does not intend to continue to do so or to enter into a municipal advisory relationship with you, the person is still considered a municipal advisor. However, in the event a municipal advisor inadvertently provides advice, the municipal advisor may be relieved from the conflicts of interest disclosures and relationship documentation requirements if it promptly, after the discovery of the inadvertent advice, provides a document to the municipal entity or obligated person that is dated and includes certain information.

The document provided to the municipal entity or obligated person should include:

- A disclaimer that the municipal advisor did not intend to provide advice and that effective immediately, it has ceased engaging in municipal advisory activities in regard to all transactions and municipal financial products to which advice was inadvertently provided;
- A notification that such municipal entity or obligated person should be aware that the disclosure of material conflicts of interest and other information as required by Rule G-42(b) has not been provided;
- An identification of all the advice that was inadvertently provided, based on a reasonable investigation; and
- A request that the municipal entity or obligated person acknowledges receipt of the document.

A municipal advisor that satisfies these requirements regarding inadvertent advice is not required to provide disclosures of conflicts of interest and other information under Rule G-42(b) and relationship documentation under Rule G-42(c) to you, but it remains subject to all other provisions of the rule.<sup>6</sup>

## Evaluating Your Municipal Advisor's Recommendations

If making a recommendation to you, a municipal advisor must have a reasonable basis to believe that the recommendation is suitable for you, based on information obtained through the reasonable diligence of the municipal advisor. If a client requests a municipal advisor to review the recommendation of another person and the review is within the scope of the engagement, the municipal advisor must determine, based on the information obtained through the reasonable diligence of the municipal advisor, whether the municipal securities transaction or municipal financial product is, or is not, suitable for the client.

For both types of review, the municipal advisor must inform you, the client, 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 the recommended transaction or product is suitable for the client;
- If reviewing recommendation made by another to the client, the basis upon which the municipal advisor reasonably believes the recommended transaction or product is or is not suitable for the client; and
- Whether the municipal advisor has investigated or considered other reasonably feasible alternatives that might also or alternatively serve its client's objectives.

Rule G-42 does not prescribe the method by which such information must be communicated to you. Your municipal advisor may choose how to do so, as long as the method of communication is consistent with the municipal advisor's obligation to act in accordance with the duty of care, and, if applicable, the duty of loyalty, the municipal advisor owes you.

In making a suitability determination, a municipal advisor must consider numerous factors that are applicable to you, and any other material information known by the municipal advisor about you and the municipal securities transaction or municipal financial product, after reasonable inquiry. The rule provides a non-exclusive list of factors that may be relevant

to your municipal advisor in making a suitability determination, including:

- Your financial situation, objectives, tax status, risk tolerance and liquidity needs;
- Your experience with municipal securities transactions or municipal financial products generally or of the type and complexity being recommended; and
- Your financial capacity to withstand changes in market conditions during the period the instrument is reasonably expected to be outstanding.<sup>7</sup>

A municipal advisor is required to “know the client,” which means it must use reasonable diligence to know and retain the essential factors concerning a client, including persons having authority to act on behalf of the client. The facts “essential” to “knowing a client” include those required to:

- Effectively service the municipal advisory relationship with the client;
- Act in accordance with any special directions from the client;
- Understand the authority of each person acting on behalf of the client; and
- Comply with applicable laws, regulations and rules.<sup>8</sup>

## Specifically Prohibited Activity

Rule G-42 specifically prohibits a municipal advisor from:

- Receiving excessive compensation;<sup>9</sup>
- Delivering inaccurate invoices for fees or expenses;
- Making false or misleading representations to you about the municipal advisor’s resources, capacity or knowledge;
- Participating in fee-splitting arrangements with an underwriter of the same transaction for which the municipal advisor is providing advice to you, and participating in any undisclosed fee-splitting arrangements with providers of investments or services to you, as the client of the municipal advisor; and
- Making payments for the purpose of obtaining or retaining an engagement to perform municipal advisory activities, with certain identified exceptions.

## Prohibited Principal Transactions

For municipal entities, a municipal advisor and any affiliate are prohibited from engaging in a principal transaction with the municipal entity that is the same or directly related to the issue of municipal securities or municipal financial product for which the municipal advisor is providing or has provided advice. An exception exists for certain fixed income securities transactions.

The specified ban on principal transactions applies only to principal transactions between a municipal advisor (or its affiliate) and a municipal entity client. The ban does not apply to principal transactions between a municipal advisor (or its affiliate) and an obligated person client, although in a transaction with an obligated person client, a municipal advisor must remain cognizant of, and comply with, for example, the broad duties of care and fair dealing that apply to all of a municipal advisor’s municipal advisory activities for an obligated person client.

“Principal transaction” includes sales or purchases of any security or entrance into any derivative, guaranteed investment contract or other similar financial product. Certain bank loans of \$1 million or more may be an “other similar financial product.”<sup>10</sup>

An exception exists for certain fixed income securities transactions executed in a principal capacity by a municipal advisor with its municipal entity client.<sup>11</sup>

The exception is subject to several conditions and limitations, which should be carefully reviewed (e.g., the exception does not apply to the affiliates of a municipal advisor and does not apply to transactions involving municipal escrow investments). Additional key terms, including the fixed income securities that may be purchased or sold using the exception are defined.<sup>12</sup>

The exception provides a municipal advisor with two options under which the municipal advisor is not specifically prohibited from engaging in fixed income securities principal transactions with a municipal entity client.

- The first option permits a municipal advisor to make the requisite disclosures on a transaction-by-transaction basis, while following a short set of procedural requirements.

- The second option allows the municipal advisor to make the requisite disclosures on an other than transaction-by-transaction basis, but the municipal advisor is subject to more procedural requirements, including a requirement to obtain prospective blanket written consent from the municipal entity client to execute such fixed income securities transactions as principal.

Although the exception removes certain principal transactions in fixed income securities from the specified prohibition in Rule G-42, the municipal advisor must remain cognizant of, and comply with, its broad fiduciary duty that applies to all of its conduct with a municipal entity client.

## Other Matters

Municipal advisors also may be subject to fiduciary or other duties under state or other laws. Rule G-42 does not supersede, for example, any more restrictive state or other federal law regarding fiduciaries.<sup>13</sup>

Rule G-42 applies to municipal advisors that advise sponsors or trustees of 529 college savings plans or similar plans or funds involving municipal fund securities.<sup>14</sup>

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- <sup>1</sup> Rule G-42 includes Supplemental Material. Paragraph .01 of the Supplemental Material provides guidance regarding the duty of care.
  - <sup>2</sup> Paragraph .02 of the Supplemental Material provides guidance regarding the duty of loyalty.
  - <sup>3</sup> Paragraph .04 of the Supplemental Material contains additional information regarding limitations on the scope of a municipal advisory engagement.
  - <sup>4</sup> Paragraph .05 of the Supplemental Material contains additional information regarding the obligations of a municipal advisor to disclose conflicts of interest.
  - <sup>5</sup> Paragraph .06 of the Supplemental Material provides guidance regarding the requirement to supplement or amend the documentation of the relationship of a municipal advisor and its client.
  - <sup>6</sup> Paragraph .07 of the Supplemental Material contains additional information regarding the requirements in connection with the provision of inadvertent advice.
  - <sup>7</sup> Paragraph .09 of the Supplemental Material provides additional information regarding the making of a suitability determination.
  - <sup>8</sup> Paragraph .10 of the Supplemental Material discusses the requirement to “Know Your Client.”
  - <sup>9</sup> Paragraph .11 of the Supplemental Material includes factors that may be relevant in determining if excessive compensation is requested or charged.
  - <sup>10</sup> See paragraph .13 of the Supplemental Material regarding the characterization of a bank loan as an “other similar financial product.”
  - <sup>11</sup> Paragraph .14 of the Supplemental Material sets forth the scope of the exception to the ban on principal transactions in Rule G-42(e) and the requirements and conditions that apply when a municipal advisor seeks to use the exception.
  - <sup>12</sup> See paragraph .15 of the Supplemental Material for definitions of key terms applicable to the exception.
  - <sup>13</sup> See paragraph .08 of the Supplemental Material.
  - <sup>14</sup> See paragraph .12 of the Supplemental Material.