The Fiduciary Obligations of Financial Advisors

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Fiduciary Obligations of Financial Advisors

- Dodd-Frank establishes standard of care that most FA's previously assumed to be the norm
- Formalizes substantive distinction in roles/duties between advisors and broker-dealers
- Puts focus squarely on real and potential "conflicts of interest" between advisors and municipal clients

Recent SEC Action

- Final registration rule adopted for MA's clarifying who is and isn't a "municipal advisor" and offering guidance on when a person is providing "advice" for purposes of the MA definition
  - Certain exemptions based on activities of advisor rather than type of participant
  - Members of governmental boards not subject to registration
- MSRB to follow with rules establishing standards for training, qualification and conduct, including treatment of conflicts of interest

2011 Draft MSRB Rule G-36 and Draft Interpretive Notice

- Duty of Loyalty:
  - Emphasizes written disclosure and informed consent regime regarding conflicts of interest
  - Introduces concept of "unmanageable conflicts" for kick-backs, fee splitting, finders fees, etc.

- Duty of Care:
  - Necessary qualifications
  - Consideration of alternatives
  - Duty of inquiry
  - Advisor not a guarantor

Potential Conflicts of Interest

- Start with premise that no relationships involving compensation are without potential conflict of interest

- Potential conflicts include:
  - Over servicing, where paid hourly
  - Under servicing, where fixed fees paid
  - Potential for "self-serving" advice where compensation is contingent or based on par amount

- Draft Rule G-36 and Interpretive Notice proposed form of "Disclosure of Conflicts of Interest with Various Forms of Compensation," by which the MA may satisfy it's obligation to provide written disclosure of potential conflicts

Other Potential Conflicts of Interest

- Excessive compensation
  - Consider focus on under compensation too?
- Dual roles or selling of multiple services within a transaction
  - Investment management, swap advisory, GO bond election services, underwriting
- Payments to or from third parties
- Non-client alliances – e.g., with underwriters, bond counsels, etc.

Still Other Potential Conflicts of Interest

- Refundings
- Use of complex products or structures
- Best addressed through client debt management policies

Ways in Which Issuers are Protected

- MA reputational risk
- Emphasize competency and experience in selection process
- Inquire about MA firm internal policies, practices, education and training
- Regulation
  - Rule G-17 – fair dealing
  - Revised Rule G-23 – no role switching
  - Proposed Rule G-36
  - Other MA rules – political contributions, gifts and gratuities, record keeping, etc.
  - Implement meaningful competency and continuing education requirement

Rulemaking Considerations

- Regime for disclosing conflicts and competency requirements are important
  - But, beware pitfalls of G-17 like disclosure. Purpose should be meaningful issuer education
- Need for other MA rules – political contributions, gifts and gratuities, etc.
- Regulation should be appropriate in scope and burden
  - MA firms are generally smaller and have far fewer resources than broker-dealers
  - Avoid overly burdensome and costly regime which drive MA's out of the market
  - MA's already are subject to a higher standard of care (e.g., fiduciary duty) than broker-dealers are
  - MA's are not selling products nor guaranteeing successful financings