CDIAC

Session Four

UNDERWRITERS AND BROKER/DEALERS:

How Has The Regulatory Regime Changed for Underwriters in the Past Five Years?

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PROTECTION OF INVESTORS

- ***Risk Alert (March 2012)***
  - *What was the risk alert?*
    - "*the [Examination Office of the SEC] has observed instances where municipal underwriters have not maintained, nor did they require the creation and maintenance of, adequate written evidence that they complied with their due diligence obligations, including those under Rule 15c2-12 and applicable Commission interpretive guidance. Indeed, some firms have asserted that it is their specific policy not to maintain any due diligence records and have stated that 'it is not industry practice" or that they are following advice from outside counsel.*"
    - Warned dealers that they need to maintain documentation that they have satisfied their due diligence obligations.
  - *Why was this such a big deal?*
  - *What did it teach us?*
    - Importance of documentation.
    - Introduction of examinations as significant business risk concern.

PROTECTION OF INVESTORS

- ***Wenatchee Order (November 2013)***
  - What happened in Wenatchee?
    - Financed project was a proposed minor league hockey arena.
    - Financing had fallen apart before.
    - Projections used in offering document had been questioned and then made to be more optimistic at the request of the city.
    - Banker was introduced to the transaction a mere weeks before it went to market and performed minimal due diligence.
  - Why is it important?
    - Negligence based enforcement action against underwriter and banker
    - Applied the emphasis of negligence-based actions to dealers in addition issuers
  - *What did this teach us?*
    - The SEC will enforce the due diligence obligations of underwriters even where a bondholder has not lost a single dollar.
    - The SEC will enforce the due diligence obligations of underwriters not only when they act recklessly but also if they do not show that they are being careful.

PROTECTION OF INVESTORS

- ***Recent Jury Verdict in City of Miami (September 2016)***
  - Recent jury verdict in the SEC's action against the City of Miami
    - Jury found that the City of Miami and its former budget director violated the Federal antifraud laws because it executed a series of transfers from its Capital Projects Funds to its General Fund, which falsely inflated the General Fund balance and maintained $100 million in reserves in the General Fund, and ultimately led to more favorable ratings on its bond offerings.
    - Jury also found that the City of Miami failed to disclose relevant facts and seek advice from its auditing firm at the time.
  - ***The SEC is using its enforcement authority to make fundamental changes in the municipal securities market, and we live in a climate where the SEC does not hesitate to open enforcement actions against issuers and underwriters – even in circumstances where bondholders are not losing money and the bonds are highly rated.***

PROTECTION OF INVESTORS

- ***MCDC Initiative (March 2014-December 2014-??)***
  - What happened?
    - Do we even need to go into that?
  - What did the dealers uncover about underwriter due diligence during the MCDC Initiative?
    - Revealed numerous instances where continuing disclosure due diligence was not conducted.
    - Revealed a lot of communication concerns between bankers and underwriter's counsel.
  - *What did this teach underwriters?*
    - A lot of assumptions were being made.
    - Need for a more-systematic process for due diligence generally—not just continuing disclosure ("canary in a coal mine").

PROTECTION OF ISSUERS

- ***Rule G-17 Disclosures (August 2012)***
  - What are these disclosures?
    - The MSRB provided an interpretation of its dealer fair dealing rule (Rule G-17) that required underwriters to provide to issuers disclosures concerning role and responsibilities of the underwriters, their conflicts of interests and the material financial risks and financial characteristics of complex transactions they recommend.
    - The interpretative notice also imposed specific requirements that underwriters deliver these disclosures early in the transaction process (some are required earlier than others depending on the kind of disclosure).
  - *How did this impact underwriters?*
    - It has required dealers to implement compliance systems to ensure that these disclosures are properly prepared and timely delivered on each transaction.
    - It has increased the amount of paper work dealers send to issuers.
    - It has provided a needed structure to disclose to issuers material factors that affect them like conflicts of interest and how risks associated with complex financings.

PROTECTION OF ISSUERS

- ***Municipal Advisor Rule (September 2013)***
  - What is the Rule and why did it matter for underwriters?
    - The Final Rule the SEC adopted concerning municipal advisors created a "facts and circumstances" test to define when a person becomes a "municipal advisor" for purposes of the brand new regulatory regime.
    - If a person becomes a municipal advisor with respect to any transaction, that person will be subjected to a host of rules including a fiduciary duty to municipal entities.
    - The SEC was clear that a dealer could not be both a municipal advisor and an underwriter with respect to any municipal securities transaction because it would constitute a breach of that fiduciary duty.
  - Underwriters are required to find an exception to the Rule
    - The effect of the Rule is that dealers need to secure an exemption for each transaction and make sure they are not municipal advisors to municipal entities on any transaction or they cannot underwrite the transaction.
    - Most underwriters looked to three exemptions: Underwriter exclusion, RFP exemption or the IRMA exemption.
  - *What is the effect of the Rule on the relationships between issuers and underwriters?*