

“Let Me Advise You on How Much to Pay Me.”
Subverting Fiduciary Duties and Rules

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Approximately 50,000 local governments and districts finance their projects and expansion by issuing municipal bonds, which are generally tax-exempt.¹ Some of these bond issuers, such as the cities of New York or Chicago, are represented by sophisticated finance personnel. These staff members understand well how these markets work and what the function and cost of underwriters are. But thousands of these bond issuers are small municipalities, school districts or water districts that do not have the sophisticated staff to design their bonds and evaluate the underwriters or their sales pitches.

The municipal bonds market has unique features. The market and the issuance are not regulated as any other public issuance of bonds. They are subject to a special regulatory regime.² In addition, these bonds are tax exempt, and attract investors who seek such bonds. Underwriters or dealers engage in buying the bonds, selling the bonds to investors, and often offering the investors liquidity by acting as dealers. Thus, underwriters and dealers play a significant role in this market. While the markets and the ways they function are becoming more complex, the small issuers of these bonds are the same small government units as in the past. The people who pay the added costs or fees or bear the unfavorable terms of the bonds are the citizens of the small municipalities, school districts or water districts and the like. It is not surprising that the underwriters and dealers in these bonds are interested in controlling such issuers. They are not interested that a sufficiently sophisticated adviser would represent these issuers in the sole interests of these issuers.

Such a group of knowledgeable and uninterested advisers has emerged throughout the years. This group of consulting advisers can guide these issuers through the complexity of issuing their bonds. The difference between these advisers and “advisers” who are related to dealers or underwriters is that these uninterested advisers do not serve in any capacity except as advisers. They do not underwrite the bonds nor have connection with any of the dealers or underwriters of the bonds. Not surprisingly, these advisers have the power to preclude certain dealers or underwriters from consideration, if the underwriting charges are too high, bond terms are unfavorable to the issuer, or services

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¹ Lisa M. Fairchild & Nan S. Ellis, *Municipal Bond Disclosure: Remaining Inadequacies of Mandatory Disclosure Under Rule 15c2-12*, 23 IOWA J. CORP. L. 439, 440 (1998) (“Over 1.5 million distinct issues are sold by more than 50,000 different state and local government entities.”).

² Issuers of municipal bonds are generally exempt from the filing and disclosure requirements of the Securities Act of 1933. 15 U.S.C. § 77c(a)(2) (Supp. IV 2004). Municipal securities brokers and dealers are regulated by the Municipal Securities Rulemaking Board (MSRB). 6 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3103.39-.42 (3d ed. 2002). In addition, the Government Accounting Standards Board (GASB) promulgates voluntary accounting principles for municipalities. 3 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1172 (3d ed. 1999). Rule 15c2-12 under the Securities Exchange Act of 1934 generally imposes further disclosure requirements on a broker or dealer acting as underwriter in a primary offering of municipal securities of \$1,000,000 or more. 17 C.F.R. § 240.15c2-12 (2005).

are inadequate. Many of the consulting advisers are members of the National Association of Independent Public Finance Advisers (NAIPFA). Some dealers offer independent advisory services. Not surprisingly, however, dealers have a strong incentive to perform both the advisory and the underwriters' functions. In such a case even if they compete among themselves, there are usually no price wars among retail or wholesale dealers. Rather, they wage their wars on accessing the issuers, and maintaining the clients' personal contacts and dependence.

To be sure, even unsophisticated issuers understand the difference between a salesperson's advice and a professional adviser's advice. At least at the beginning of the relationship, the issuer will treat a salesperson differently, because it is clear at that point that the sales talk is tilted to induce sales for the benefit of the salesperson. Advice, in contrast, is designed to benefit the issuer because an adviser has no personal interest except to increase the well-being of the issuer.

The practice in this area, however, is a combination of the two modes of services. Some broker-dealers and underwriters approach issuers as advisers, and design the bond issues and the terms of the bond distributions. Thereafter, however, some of them resign as advisers and reappear as dealers and underwriters for the same bond issue that they designed as advisers and the same issuers that they served as advisers. This metamorphosis produces serious conflicts of interest not only when the change occurs but at the start of the process.

A salesperson that appears in an adviser's clothes and acts as a consultant, gaining the issuer's trust, might retain the issuer's trust even after changing his status into a salesperson who would benefit from getting the brokerage business. That occurs even though, as adviser, he advises the issuer about the dealers and underwriters that the issuer should employ. Personal trust and confidence in a relationship lingers on, even when the adviser reappears in another capacity. Thus, acting in the capacity of an adviser, a salesperson can gain the issuer's deeper trust. After he "resigns" and reappears the next moment as an underwriter he has a good chance of gaining the business about which he advised the issuer.

Issuers might question the true commitment of underwriters that introduce themselves as independent advisers first, and then change their status to that of underwriters. But these so-called advisers do not represent themselves as potential underwriters. They represent themselves first as advisers to be entirely trusted, without any suspicion of conflicting interests. Once the relationship is established, unsophisticated issuers cannot easily reduce their reliance. The personal trust in the relationship takes over. Then, and only then, do these so-called advisers change their status to become the dealers and underwriters.

When issuers recognize that a conflict of interest exists at the outset, the issuers are less likely to rely on the salespersons, and more likely might to seek additional independent opinion. But if the issuers do not recognize a conflict of interest, they are more likely to rely on the advice. In sum, advisers who plan to become dealers and

underwriters misrepresent who they truly are and defraud the issuers into trusting that is not justified.³

The conflict between independent advisers and the underwriters and dealers has been fierce and politicized. For example, a South Carolina legislator proposed to require “municipal bond issuers in the state to use only dealers, and not independent firms, as financial advisers.”⁴ “The [proposal] was ostensibly designed to ensure that state and local issuers would use only firms that are knowledgeable and qualified in the financial advisory business.”⁵ Clearly it would have given the dealers the exclusive monopoly in this market and would have excluded independent advisers from the market. Having caused a “furor,” the proposal was withdrawn.

However, “NAIPFA recently lost a bid to get the MSRB to overhaul its Rule G-23 on dealer-financial advisers, which it claimed was being circumvented by dealers in some states. The rule allows a dealer-FA to resign as FA and serve as underwriter on the same bond deal as long as the dealer discloses potential conflicts of interest to the issuer and gets the issuer's permission for the role switch. The disclosure does not include disclosure about actual conflicts of interests nor the nature and extent of these conflicts. Moreover, the rule does not require that the disclosure be made to the issuers' policy makers or that those policy makers consent to the fundamental change in roles of the adviser to a dealer or underwriter. The rule does not require resignation and termination of the relationship between the issuer and the so-called adviser turned dealer. The rule requires only termination of the relationship with respect to the specific transaction, but allows the advisory relationship to continue with respect to other transactions. . Thus, the rule allows the dealers to be clothed simultaneously in two sets of garments. The same dealers can be advisers who have no relationship to dealers and underwriters and dealers. They can thus have no relationship to themselves which they obviously do. Needless to say, this is a very confusing situation for unsophisticated issuers. In fact, this is confusing for sophisticated issuers as well. Dealers opposed any changes to the rule, and the MSRB decided in February of 2006 that “revisions were not warranted at the time.”⁶ The Board offered no explanation for this decision. Arguably, the MSRB could be influenced by dealers because the membership of the board includes some dealers.⁷ But I will assume

³ See generally, Tamar Frankel, *TRUST AND HONESTY, AMERICA'S BUSINESS CULTURE AT A CROSSROAD* 59-78 (2006).

⁴ Lynn Hume, *SC Lawmaker Defuses Furor over Financial Advisers*, BOND BUYER, May 19, 2006, LEXIS, News Library, Curnws File; Lynn Hume & Tedra DeSue, *Bill Would Promote Dealer FAs*, BOND BUYER, Apr. 24, 2006, LEXIS, News Library, Curnws File.

⁵ Lynn Hume, *SC Lawmaker Defuses Furor over Financial Advisers*, BOND BUYER, May 19, 2006, LEXIS, News Library, Curnws File (“The amendment, which drew strong opposition from the National Association of Independent Public Finance Advisors and added fuel to the group's fight with dealers over the Municipal Securities Rulemaking Board's Rule G-23, stated: ‘Only a municipal securities broker or dealer may provide financial advisory services to issuers.’ Issuers were defined as any state or local political divisions or subdivisions in South Carolina.”).

⁶ *Id.*

⁷ Municipal Securities Rulemaking Board, *About the Board*, <http://www.msrb.org/msrb1/whatsnew/default.asp> (last accessed Nov. 6, 2006) (“The Board consists of 15

that that these dealers are concerned about the integrity of the municipal bonds markets and have no conflicts of interest in this matter.

The legal status of advisers who convert to dealers and underwriters

Fiduciaries and sales persons: Misleading mixed status. The world of advisers is varied and their liabilities and responsibilities differ.⁸ While definitions of fiduciaries differ, all definitions describe fiduciaries as persons or organizations which are entrusted with power or property. Let us call those that entrust fiduciaries with power or property “entrustors.” The power can be the power of expertise, or power to bind others to legal liabilities, or power to offer advice on which others must rely, by the nature of the relationship.

Why would anyone entrust others with power or property? The answer is that our country’s prosperity is built on trust and specialization. If we could not trust the food prepared by others, the houses built by others, the advice of the doctors and lawyers and investment consultants, we would have to do all things ourselves and learn all professions ourselves. Since no one can do all this in a lifetime each of us would have to focus on the essentials to survive: food and shelter. The rest of the services would not be offered or received. Reliance on others is essential to our standard of living and way of life. Reliance on others, however, does not mean trusting others under all circumstances. We can rely and yet check the truth of what others say and performance of others’ promises. And in some cases we can indeed do that with little effort. When buying a newspaper we can check the name and date of the paper and pay for it in an immediate exchange for paper. But if we wish to know how to invest our life savings, reliance cannot be accompanied by verification. We must rely and trust the organizations that give us advice. That is sometimes because we lack the expertise of the advisers, and because acquiring the expertise is costly and time-consuming.

It must be emphasized, however, that before we hire an adviser our bargaining power is greater than, or at least equal to, that of the adviser. After all, the adviser depends on us for its livelihood. But after the deal is struck, and after I decide to rely on the advice, the balance of power changes. I must rely on the advice or pay anyway. My weakness vis-à-vis the adviser stems from the very nature of our relationship. Without trust the advice cannot be used at all. Even experts might wish to hire advisers if the experts are engaged in other activities. To examine the advice would undermine the very utility of the relationship.

Public policy is designed to support some services, such as lawyers’ services, medical treatment, teaching, and investment advice. Hence, the law supports the trust in, and reliance on, advisers by imposing fiduciary duties on advisers. Not all advisers are

members- five representatives of bank dealers, five representatives of securities firms, and five public members not associated with any bank dealer or securities firm.”).

⁸ See generally Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983); Robert W. Doty, *Issues in Debt Management*, GOV. FIN. REV., Aug. 1, 2001, at 38.

required to follow the same duties. The existence of the status and consequent duties are linked to the nature, complexity, and seriousness of the services.

Advisers to small municipalities and government districts should be bound to a high level of duties within the scope of the employment for a number of reasons. First and foremost, those who make the decision whether to engage an adviser in connection with the issuance of municipal bonds are themselves fiduciaries. They represent the populations of the municipalities and districts. The money they are raising and spending is not their money. It is the power and money of the residents of the municipalities and districts, who have voted for the government representatives. These representatives were entrusted with power to raise funds and use the funds for the benefit and better life of the residents. Thus, these leaders of the communities are required and expected to do the best for their communities: receive the best advisory services for the least amount of cost. Further, the leaders must select the advisers who are most trustworthy and qualified. That is especially so when the leaders are not experts in the design of bonds, the markets for the bonds and the cost of distributing the bonds.

Second, advisers who help such leaders must follow strict fiduciary duties. By definition, being advisers renders them fiduciaries, regardless of how sophisticated their clients are.

Third, fiduciary duties differ from the contract duties. That difference exists even though both contract and fiduciary relationships are based on the consent of both parties. No one may force the fiduciary and entrustor, or the parties to a contract, to enter the relationship. Besides, most contracts involve some degree of trust. The difference, however, is crucial. In contract the parties understand that they have conflicting interests even as they desire to enter into a relationship. A seller wants the most for his product and the buyer wants to pay the least for the product. The seller may want to be relieved of any guarantee as to the quality of the product, while the buyer may require a guarantee. And so on.

Fiduciary relationships are based on an entirely different understanding. **With respect to the entrusted property or power** the parties understand that the fiduciary acts for the sole benefit of the entrustor. The adviser may not give advice which benefits the adviser. The adviser has an affirmative duty to advise the client and act in the client's best interests. The money manager may not manage the entrustor's assets that benefits the adviser. The doctor may not perform an operation except for the sole benefit of the patient. The lawyer may not handle the client's legal affairs except in the client's best interests.

There are two exceptions to this rule. One exception is by the law that permits the fiduciary to benefit from the relationship. The second exception is by the entrustor that permits the fiduciary to benefit from the relationship. That permission is valid only after the fiduciary provides the entrustor with full information. Under some circumstances the adviser may not benefit even if the entrustor agrees to the benefits. There is no exception

for those who masquerade as advisers free of conflicts of interest if in fact they do have such conflicts in mind. These advisers are gaining the clients' trust by deceit.

Dealers' advice offers a good example. Dealers, acting as principals, who advise clients have conflicts of interests. The dealers may at times give clients inappropriate advice even if they do not clearly violate the law. Such an advise may result in the sale to clients of securities or products that may not be in the clients' interest, or to sell clients securities or products at higher prices than others might offer. However, clients who receive the dealers' "advice" are not misled. They know that the advice is "sales advice" which salespersons provide prospective buyers. That advice is taken with a grain of salt, or is ignored altogether.

But clients who receive advisers' advice, and who do not know that the advisers will resign and change their status to become underwriters *with respect to the same transactions*, have been misled. Those advisers had conflicts of interest *while acting as advisers, even though they seemed to have no conflicts*. In fact, these so-called advisers harbored conflicts from the first moment they began to serve as advisers. Their conflicts of interest are pernicious because they have expertise and information that the client lacks. As advisers, their expertise and information is offered to the clients for the clients' sole benefit. As dealers and underwriters, the expertise and information is used either for the sole benefit of the dealers and underwriters or in part for their benefit. Perhaps the dealers are not greedy and offer advice that may not harm the clients as much as the dealers could. But human nature being what it is we can assume that the dealers offer the clients the best deal for the dealers and not the best deal for the clients, unless the two deals are identical.

Assume that the so-called "advisers" did not intend to resign and become dealers or underwriters. Assume that the idea occurred to them only later, after they had been hired as advisers. Even then, they may not change their position and become underwriters without explaining to the clients clearly that (1) as underwriters they are dealing solely as principals with their advisee-issuer clients, and (2) that they have conflicts of interest with the interests of the clients and (3) what the nature and extent of the conflicts may be. Unsophisticated clients might believe that these underwriters are still devoted fully to the clients' interest (especially so, if the advisory contracts remain in effect), while in fact the underwriters are not, and cannot be, so devoted. They are likely to prefer themselves to those of the clients. The conflict of interest taints their judgment.

The same issue has risen on a large scale in other contexts. When financial planners offered their free planning and collected commissions from any sale of financial products, which they advised the clients to buy, the Securities and Exchange Commission held that these financial planners were advisers, and required them to register as advisers under the Advisers Act of 1940.⁹

⁹ Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092, 1987 SEC LEXIS 3487 (Oct. 8, 1987) (footnote omitted):

The story of Mark Ferber demonstrates the argument.¹⁰ “Mark Ferber, an ex-partner at Lazard Freres, was convicted on 56 counts of fraud and corruption. Ferber failed to disclose a \$1 million retainer and fee-splitting agreement that he had with Merrill Lynch to steer clients to Merrill's services.”¹¹

The conflict between fiduciary law and contract law was debated in this case.

For some, the Ferber issue was incredibly clear. . . . Financial advisers should act in a fiduciary capacity for their public clients. For others, the issue is murkier. They argue that, in the absence of a demonstrable monetary loss due to fraud, the financial adviser owes the issuer nothing other than what is in the contract. That is, to give stipulated services no matter what might be the mix of loyalties and sources of remuneration.¹²

The contract argument considers the transaction a sale of advice. What the contract argument does not take into consideration is the price that the clients pay for the tainted advice, as much as any clients pay for advice that is tainted with bribery. The service provider, who paid \$1 million to get this and other deals, is willing to charge for its services the amount it received from the clients **minus** the \$1 million it paid to the bribed fiduciary. The clients pay more than they would have paid had their adviser refrained from receiving the bribe and bargained with the service provider. The clients are harmed to the tune of \$1 million, which was diverted to the adviser. Therefore, the adviser did not perform as promised. He recommended a provider that charged more than it would otherwise have. The adviser was not a good adviser after all.

As a general matter, if the activities of any person providing integrated advisory services satisfy the elements of the definition, the person would be an investment adviser within the meaning of the Advisers Act A determination as to whether a person providing financial planning, pension consulting, or other integrated advisory services is an investment adviser will depend upon whether such person: (1) provides advice, or issues reports or analyses, regarding securities; (2) is in the business of providing such services; and (3) provides such services for compensation.

See also Certain Dealers Deemed Not to Be Investment Advisers, Investment Advisers Act Release No. 2376 (Apr. 12, 2005), 70 Fed. Reg. 20,424 (Apr. 19, 2005) (to be codified at 17 C.F.R. § 275.202(a)(11)-1(b)(2) (generally denying financial planners exception from Advisers Act registration for “a broker dealer providing advice that is solely incidental to its brokerage services” is excepted from the Advisers Act from Advisers Act registration for broker dealers”).

¹⁰ John E. Petersen, *A Cleaner, Leaner, Meaner Municipal Market*, GOVERNING MAG., Nov. 1996, at 57, LEXIS, News Library, Arcnws File.

¹¹ *Id.*

¹² *Id.*

In addition, such an adviser is generally unreliable. If he collects bribes in one way or another, by direct favors or by reciprocating for other favors that it received, all these valuable favors are paid at the expense of the clients, in one way or another.

The current scene in the municipal bonds market. Our citizens pay for tainted advice. Rule G-23.

“[T]he prevailing norm in many areas is for the financial adviser to first advise and then to resign and underwrite the securities or for advisers to also serve as providers of investments. Advisers who play both sides of the market insist that their constant involvement in various parts of the transactions gives them superior skills and information. But advisers who are independents (and only serve as advisers) argue that rotating roles leave the firms vulnerable to conflicts as they are in the position of selecting or being selected by firms with whom they variously compete and cooperate. Rule G-23 of the MSRB allows firms to act in both capacities but not at the same time on the same transaction. Of course, being able to look forward to making money on the underwriting or on the investment agreement (where money-making occurs after the firm has ceased to serve as the adviser) allows the firm to price its advisory services very reasonably. That, of course, can be an effective way to block out competition from those who are only paid for the rendering of advice.¹³

Rule G-23 was established in the early 1970s.¹⁴ The rule’s “purpose and intent” was “to establish ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers of municipal securities.”¹⁵ Thus under the rule financial advisers could act as dealers with respect to the advice that they give. In the area of advisory services, financial planners who advise clients on their asset allocation and asset choices offer their advice free and receive their compensation by commissions based on the transactions that they recommend. However, these financial planners must register as advisers under the Advisers Act of 1940. This registration subjects them to disclosure requirements before the engagement as advisers,¹⁶ to fee constraints,¹⁷ as well as to criminal sanctions for misleading and fraudulent activities.¹⁸

Under rule G-23, there are three ways in which dealers can serve as financial advisers to municipal issuers. One way is for dealers to offer financial advisory services

¹³ *Id.*

¹⁴ *In re* Mun. Sec. Rulemaking Bd., Securities Exchange Act Release No. 15,247, 1978 SEC LEXIS 515 (Oct. 19, 1978).

¹⁵ Rule G-23(a), MUN. SEC. RULEMAKING BD. MANUAL (BNA), ¶ 3611, at 5052, 5052 (July 1999).

¹⁶ 15 U.S.C. § 80b-6(4) (2000); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, 200 (1963) (citing statute).

¹⁷ 15 U.S.C. § 80b-5(a)(1) (2000) (prohibiting performance fees).

¹⁸ 15 U.S.C. § 80b-6 (2000) (prohibiting fraud); 15 U.S.C. § 80b-17 (2000) (providing for criminal sanctions).

without offering underwriting services. This relationship avoids or minimizes conflicts of interest.

The second way is to offer underwriting services, and in the course of those services to offer advice. In this case the dealers wear their underwriter hats but not the advisers' hats.

The third way in which the dealers can offer advisory services to municipal issuers is to offer the services first, then resign as advisers, and then put on their underwriter hats. Thus, the rule prohibits anyone from serving as adviser and dealer at the same time.

The rule, however, allows dealers to do so sequentially with respect to the same transaction. They can advise first, and when they finish advising they can resign and become overnight underwriters to perform the same transaction. They need only make disclosure to, and obtain consent of, some issuer official (not necessarily a policy maker). They need only disclose that a conflict of interest "may" exist, not that there actually is a conflict. They need not disclose the nature of the conflict or what it means for the issuer client.

Further, that metamorphosis can be achieved in an instant. Adviser finishes its advisory role and in the next minute it can offer services in a dealer or underwriter role. What effect could this change have on an issuer who is used to the adviser? My assumption is that with the right form of presentation the effect is zero. The issuer continues to view the adviser with trust that this adviser did not earn.

What are the consequences for the issuer of this "technicality"? An adviser to municipal issuers is expected to represent the issuers in their negotiations with the underwriters. In this case the "technicality" enables the adviser to represent himself and the issuer at the same time, and conduct the negotiations on both sides of the table. The more expert this adviser-underwriter is, the more helpless the municipal issuer becomes because the gap of expertise between the issuers and the adviser-underwriter becomes wider. There is no way in which most municipal issuers can examine the terms of the underwriting and bargain with the new-old underwriter who the day before was their trusted adviser on the same issuance. There is no way in which the citizens who are paying for this tainted arrangement can protect themselves from expert underwriters who wear the advisory clothes and negotiate for the citizens and for themselves at the same time.

This situation requires a change. One change can be achieved by media disclosure. Let the citizens of the various municipal districts be aware of the fact that their representatives trust the salespersons as if they were true advisers rather than sales-advisers. Let the citizens demand of their representatives to impose conditions on their advisers and refuse to consent to their conversion into underwriters. When dealers provide advice, the representatives of the public must understand that the advice is tainted with conflicts of interest.

Another change can be achieved if the citizens demand that the Board amend rule G-23 to preclude this deceptive and confusing practice. For example, an adviser who will become an underwriter must notify the issuer in advance of such a possibility at the outset of the relationship and of the conflicts that will result from the changing status, and is disqualified from so underwriting if it failed to give such advance notice. Or barring a notice, the adviser should be disqualified for a specified period from the date on which the services were provided with respect to the same transaction or issuance. There may be other ways in which the issue could be addressed. The point of this paper is to make it clear that the current situation presents unacceptable conflicts of interest, which can be very costly to the citizens of many small towns and districts. Their trust in their advisers should be justified. Their advisers should be true advisers.