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Municipal Securities Rulemaking Board  
Attention: Mr. Ronald W. Smith  
Senior Legal Associate  
1900 Duke Street Suite 600  
Alexandria, VA 22314

Ladies and Gentlemen:

The National Association of Independent Public Finance Advisors (“NAIPFA”) respectfully submits these comments to the Municipal Securities Rulemaking Board with respect to the Board’s Rule G-23. We appreciate the Board’s review of Rule G-23.

NAIPFA submitted to the Board an initial comment letter dated October 28, 2005. We hereby reaffirm the views we expressed at that time, and incorporate that letter herein in all respects.

NAIPFA believes that developments in our market over the past 30 years have rendered Rule G-23 in its present form inadequate to address current market practices and potential abuses. Our proposals would afford issuers in the state and local government securities market the benefits of enhanced disclosure and would help to assure that issuers avoid conflicts of interest while preserving choice in the selection of financial professionals.

At the outset, it may be helpful to provide an overview of NAIPFA’s positions regarding Rule G-23. NAIPFA supports continued maintenance of issuer choice of underwriters, pursuant to appropriate procedures even when the underwriters may have served previously as financial advisors in the same transaction.

NAIPFA’s concerns focus on: (1) the form and content of disclosure by dealers to issuers when dealers serving as financial advisors to the issuers resign, or intend to resign, to underwrite the issuers’ securities; (2) disclosure and decision-making procedures, such as the parties to whom disclosures should be directed and who should approve dealer resignations; and (3) prohibition of deceptive practices that offer significant potential for misleading thousands of small unsophisticated issuers and inhibiting competition.<sup>1</sup>

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<sup>1</sup> The Missouri State Auditor cited the significant impact of the noncompetitive effects of dual service by dealers as financial advisors and underwriters, noting that, in the face of the dual service that occurs in most Missouri municipal securities issues, while 41 underwriting firms had purchased bonds in Missouri since 1997, only “3 of



Not only NAIPFA, but also issuer and state officials and legislation strongly oppose the conflicts of interest resulting from dealer service in dual roles in the same transactions. In 1994, the Government Finance Officers Association adopted a recommended practice stating that issuers should, “avoid using a firm to serve as both the financial advisor and underwriter of an issue because conflicts of interest may arise.”

The Florida Supreme Court held in *Miami v. Benson*<sup>2</sup> that public policy is violated when a dealer serves as both financial advisor and underwriter, citing the maxim that, “No man can serve two masters.”

Recently, following its audit of bond sale practices in Missouri, the State Auditor criticized the conflicts existing when firms serve in both capacities, asserting that, “In most private sales, the bond underwriters who purchased the bond issues also served as the financial advisor ....”<sup>3</sup> That finding illustrates how the dealer practice of assuming dual roles is prevalent in selected geographic areas.

The severely detrimental consequences of such abusive practices are illustrated by the Missouri State Auditor’s finding that, “private sale bond buyers, or underwriters, have practically closed the Missouri bond market to potential out-of-state bidders.” The Auditor added that this “results in higher interest rates and overall costs to the issuing political subdivision.”<sup>4</sup>

The California legislature adopted legislation that declared the practice of switching from financial advisor to underwriter for negotiated sales not only wrong, but illegal.<sup>5</sup>

### **Current requirements and procedures for disclosure to issuers are inadequate**

#### **1. An actual, rather than simply a potential, conflict of interest exists**

No serious participant in the municipal market believes a financial advisor can serve as an underwriter without engaging in direct conflicts of interest with the issuer. Actual and direct financial conflicts exist at numerous points in bond transactions:

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the 41 underwriters bought about two-thirds of the total purchases.” Office of the Missouri State Auditor, Performance Audit, Report No. 2001-04 (Jan. 29, 2001) (“Missouri Auditor’s Report”).

Clearly, Missouri issuers did not have to employ their financial advisors to purchase the issuers’ securities in order to sell those securities. There was a substantial available underwriting pool. The prevalent conditions in Missouri highlight the failure of dealers seeking dual service to advise their issuer clients as to the optimal mechanisms and availability of competing firms for marketing the issuers’ securities.

<sup>2</sup> *Miami v. Benson*, 63 So.2d 916 (Fla. 1953).

<sup>3</sup> Missouri Auditor’s Report, n 1, *supra*, Executive Summary at 2.

<sup>4</sup> Missouri Auditor’s Report, n 1, *supra*, at 19.

<sup>5</sup> California Government Code Section 53591.



- a. **In negotiating underwriter compensation.** Without an independent financial advisor,<sup>6</sup> an issuer has no basis for determining an appropriate underwriting spread for a transaction. Even small differences of 50 cents per bond can mean several thousand dollars in additional compensation to the underwriter and cost to the issuer.

Most issuers do not have independent access to data allowing them to verify appropriate underwriter compensation. In addition, issuers without independent financial advisors are often victim to bogus expense claims for items such as “computer time”, “structuring fees” and “clearance fees.” Issuers sometimes even lack the resources to ensure that the agreed fees are calculated correctly.

- b. **In pricing of securities.** Because underwriters must also represent the interests of investors, a clear conflict exists with the issuer’s goal of achieving the lowest cost of capital. In contrast, investors want the highest yields possible. Further, underwriting is an arm’s-length transaction conducted by the underwriter dealing with the issuer as a principal.

The broker/dealer cannot avoid its responsibilities to investors. Additionally, in cases in which the underwriter is taking securities into inventory, or underwriting unsold balances, there are direct conflicts between the issuer/seller and the underwriter/purchaser. The underwriter will want higher yields to assist in liquidation of its inventory.

The overwhelming majority of issuers do not have access to comparative pricing data, index information such as MMD, Delphis, or *The Bond Buyer*, other pricing and market sources, or indeed any means to properly negotiate their transactions absent an independent financial advisor.

Clearly, reliance solely on underwriters to provide this information is not in the financial interests of issuers.

- c. **In structuring prepayment and other terms of the transaction.** The use of premium and discount bonds can affect the pricing and market acceptance of all securities issues. While the use of these techniques often is positive, most issuers without independent financial advice have an insufficient ability to validate the advisability of these structures.

When abused, premium bonds can lead to excessively high coupons, over issuance, and misleading pricing if call provisions are not appropriate for the bonds. Excessive discount bonds lead to a loss of refunding ability and create the potential for market intermediaries unidentified to issuers to “flip” the bonds in the secondary market at better prices, lower yields, than were achieved by the underwriter at pricing. Call provisions have a direct impact on the value of bonds.

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<sup>6</sup> As used in this letter, the term “independent financial advisor,” means a financial advisor to the municipal securities issuer who is independent of the underwriter. That advisor may be another dealer or a non-dealer.



Without independent financial advice, most issuers do not have the information, experience or tools to evaluate the effect of these structural issues on their transaction.

- d. In private or limited placements.** We have been surprised by market data indicating the number of private and limited placements in which the financial advisor and underwriter/placement agent were the same. We have even seen examples in which the securities were placed with the underwriter. The conflicts between issuer and purchaser are direct and self evident.
- e. In negotiation of Bond Purchase Agreements.** In the absence of independent financial advice, the potential exists for underwriters to use the Bond Purchase Agreement to extract excessive indemnification, provide excessive conditions to the underwriters' obligations to purchase securities, "lock up" future refundings, and, in the absence of the issuer's understanding that such Agreements are negotiable, impose other provisions that are not in accordance with sound public policy.

Without independent advice, many issuers are unaware of the extent to which those terms are subject to negotiation. Some Bond Counsel do not render advice to issuers on such matters, and in those instances, cannot and should not be relied upon to represent the issuer on BPA related issues.

- f. In development of security provisions.** Particularly when they take bonds into inventory, underwriters have an interest in developing the most strict and limiting security provisions possible for the transaction to protect their own stake and those of their investor clients. Investors also want stronger security. Issuers, on the other hand, have an important interest in seeking a balance in security provisions in order to accommodate future funding for other essential public services.

Without independent financial advice, most issuers do not have the information, experience or tools to determine which security provisions represent market standards and are necessary or appropriate, as against those that serve primarily the benefit of the underwriter and investors.

- g. In procurement of credit enhancement.** Without independent financial advice, most issuers do not have the information, experience or tools to make a judgment about the relative value and necessity of multiple ratings and credit enhancement options.

This is a particular concern when the underwriter is also affiliated with a credit enhancement provider, either corporately, or through a joint marketing agreement. Increasingly, underwriting firms are under pressure to "cross market" additional services.

In the absence of independent financial advice, most issuers do not have the information, experience or tools to form a basis for determining the pricing, necessity or advisability of these additional services.

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- h. In provision of swaps, investments and other products.** While IRS regulations have addressed the most egregious abuses, such as yield burning, bid rigging, collusion, provision of securities from dealer portfolios, and the like, these examples provide a vivid reminder of the potential for abuse absent independent financial advice.

In light of the aforementioned reasons, NAIPFA recommends that, **Disclosures by dealers resigning as financial advisors should be required to advise issuers affirmatively that several actual conflicts of interest exist when financial advisors resign to become underwriters. The affirmative advice should identify the nature and extent of all material conflicts of interest, as well as other material potential impacts of those conflicts upon the issuer clients.**

To initiate the process of development of disclosure language, we offer the following specific suggested formulation:

In resigning as your financial advisor in order to serve as an underwriter of your securities, the prior relationship between us, as your financial advisor, on one hand, and you, on the other, will become fundamentally different. In the future, that relationship will entail direct, financial and other conflicts of interest between you and us on numerous issues related to the pricing, structuring, issuance and sale of your securities. Those conflicts of interest include, among others: determining our underwriting compensation; structuring of the securities, including without limitation, interest rates and yields, call provisions and security; placement or sale of the securities with specific investors; terms of the Bond Purchase Agreement; procurement of credit enhancement; and provision of swaps, investment securities and other products.

As your financial advisor, we have had, and until our resignation is complete and you have accepted it, we will continue to have, a duty to provide you with affirmative advice in your best interests. As an underwriter, however, in the future, we will no longer have that relationship with you. Instead, we will act in an arm's-length relationship dealing with you solely as a principal.

In addition, in the future, as underwriter, we will have duties to investors, and we will be able to act solely in our own interests, in each case in ways that are in direct conflict with your interests as an issuer.

Accordingly, you should not rely solely on information provided by us as underwriters in making decisions regarding your securities transaction, but instead you should make your own independent judgment regarding that information. If you do not retain a separate, independent financial advisor, you may find it difficult or impossible to obtain objective information on the matters enumerated above and other information critical to your interests with which to negotiate your securities issue and the transaction with us.

## **2. Rule G-23 does not cover interest rate exchange (swap) agreements**

At the time G-23 was adopted, swaps were not widely used in the municipal securities market. In recent years, they have exploded in popularity among municipal issuers.

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When a dealer is a direct counterparty to a swap transaction, the conflicts between the issuer and the dealer serving as counterparty are self-evident. Many issuers are unaware however, that compensation in swap transactions is built into the swap rate. Commonly, dealers do not inform issuers as to the compensation the dealers receive in such transactions.

Without access to expensive and complex real-time financial data, issuers cannot negotiate swap pricing with a counterparty from a position of knowledge. Without a financial/swap advisor, an issuer cannot determine comparative swap spreads, or even the mid-market swap level to base compensation.

As swaps have proliferated, we have seen a substantial decline in swap spreads from usually more than ten basis points to, in some cases, four basis points or less. We now know that issuers can have potential tax liability from mispriced swaps and that it is imperative that they have independent swap pricing and other advice at the time they enter into the transactions.

Financial advisors who switch from providing independent advice to serving as a swap counterparty deny their clients the value of independent advice at a time when it is seriously needed.

Therefore, NAIPFA recommends: **Dealers should be prohibited from serving as swap counterparties in transactions in which they are financial advisors to issuers.**

**3. Financial Advisors are deemed by the SEC to be fiduciaries to issuers; underwriters serving solely as principals are not**

As we pointed out in our October 28, 2005, letter to the Board, the SEC, the courts, and the Board itself, have asserted that financial advisors have fiduciary duties to issuers. Those asserted fiduciary duties simply are not present in the arm's-length principal relationship that characterizes the role of underwriters.

Issuers are generally unaware of those distinctions. The current version of Rule G-23 does not provide adequate notice to issuers that, as a consequence of a dealer's resignation, the fundamental nature and character of the advice to be rendered to the issuer is altered drastically. Indeed, by permitting resigning dealers to suggest to issuers that there is no change in responsibilities or the nature of the advice received, Rule G-23's current formulation permits dealers to mislead issuers in a material manner as to significant aspects of the resignations.<sup>7</sup>

Issuers, therefore, being accustomed to accepting and relying upon the advice of their trusted financial advisors, may not realize the significant and fundamental alterations occurring

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<sup>7</sup> Of course, other securities law requirements apply. For example, SEC Rule 10b-5 prohibits the, "mak[ing] [of] any untrue statement of a material fact or [the omission] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, ... in connection with the purchase or sale of any security." See, e.g., *In the Matter of Lissack*, SEC Rel. No. 34-39687 (Feb. 20, 1998) (affirmative underwriter misrepresentations as to savings from refunding under changing market conditions).



in the character of that advice and the relationship of the advisors to the issuers. That is particularly true in, but is not limited to, instances in which advisors resign only briefly or only partially for participation in a specific transaction in connection with preservation of continuing financial advisory contracts. This is why a resignation must be for a specific term in order to be meaningful.

The following represent only a few of the many actions in which the SEC has considered financial and investment or other advisors to municipal securities issuers to have fiduciary duties to issuer clients, even large sophisticated issuers, to make affirmative disclosure of conflicts of interest.<sup>8</sup>

An SEC Administrative Law Judge held that a financial advisor should have disclosed to a large issuer, Broward County, Florida, the advisor's employment of a political consultant to obtain the County's business, because:

First Union was Broward's financial advisor under the FA Agreement and owed it a fiduciary obligation to disclose material matters ...<sup>9</sup>

The SEC asserted that a financial advisor to the Commonwealth of Pennsylvania should have disclosed fee splitting:

As financial adviser, Arthurs Lestrangle and Bova occupied a position of trust and confidence on the Pennsylvania Refundings. Bova was thus required to disclose all material facts to the Commonwealth fully and completely.

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Generally, a financial adviser to a state or local issuer owes fiduciary obligations to it in connection with bond financings by the issuer.<sup>10</sup> Arthurs Lestrangle also was a fiduciary

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<sup>8</sup> NAIPFA's continuing education programs, in which Certified Independent Public Finance Advisors participate in order to retain their certifications, emphasize these and other regulation of our business activities.

<sup>9</sup> *In the Matter of Wheat, First Securities, Inc., et al.*, SEC Initial Decision Rel. No. 155 (Dec. 17, 1999).

With respect to requirements for disclosure to another large issuer, Fulton County, Georgia, see *U.S. v. DeVegter and Poirer*, 198 F.3d 1324 (11th Cir. 1999); *In the Matter of DeVegter*, SEC Rel. Nos. 33-8645, 34-53009, IA-2465, IC-27196 (Dec. 22, 2005) (financial advisor's failure to disclose conflicts of interest in selection of underwriter).

<sup>10</sup> The following is the SEC's footnote, citing among other things, the MSRB's position asserting that financial advisors are fiduciaries:

*See, e.g., Order Approving Proposed Rule Change of MSRB Relating to Activities of Financial Advisors*, Exchange Act Release No. 30258 (Jan. 16, 1992) ("The MSRB ... believes that the existence of the conflict of interest [faced by a dealer acting as both financial advisor and placement agent on the same issue] is contrary to the fiduciary obligations of municipal securities professionals acting as financial advisors to issuers ..."); *Notice by MSRB of Proposed Rule G-23*, 42 Fed. Reg. 49856, 49859 (Sept. 28, 1977) ("As a financial advisor, the municipal securities professional acts in a fiduciary capacity as agent for the governmental unit ..."); *cf. In re O'Brien Partners, Inc.*, Securities Act Release No. 7594 (October 27, 1998) (violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act for failure to make full disclosure in breach of fiduciary duty owed as municipal



under Pennsylvania law because the Commonwealth reposed trust in the skill and integrity of Arthurs Lestrage as its financial adviser, and the Commonwealth had a, “just foundation for belief” that Arthurs Lestrage was acting in the Commonwealth’s best interest.<sup>11</sup>

The SEC also asserted that a financial advisor to a small New Jersey issuer was obligated to disclose material conflicts and other material information when the advisor sold investment securities to the issuer:

This is a municipal finance case involving the breach of Lazard’s fiduciary duty to its financial advisory client, the Passaic Valley Sewerage Commissioners (“Passaic Valley”). The breach of duty involved Lazard’s failure to make necessary disclosures in an advance refunding transaction in which it served as financial advisor and also sold Treasury securities to Passaic Valley as principal.

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Generally, a municipality’s financial advisor owes fiduciary obligations to it in connection with bond financings by the municipality.<sup>12</sup> In addition, under New Jersey state law, a fiduciary relationship arises when one person is under a duty to give advice for the benefit of another on matters within the scope of their relationship and the advisor occupies a dominant position over the other.<sup>13</sup> Passaic Valley had no expertise or experience in advance refundings or purchasing Treasury bonds and notes. Instead, Passaic Valley relied on Lazard, as its financial advisor, to serve its interests in all aspects of the refunding, including the purchase of escrow securities. Therefore, based on the facts and circumstances, Lazard had a fiduciary or similar relationship of trust and confidence with Passaic Valley.<sup>14</sup>

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financial advisor). The term financial advisor is not defined in the federal securities laws. However, Rule G-23(b) of the Rules of the Municipal Securities Rulemaking Board provides that, “a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of such services.”

<sup>11</sup> *In the Matter of Arthurs Lestrage & Co., Inc., et al.*, SEC Rel. Nos. 33-7775, 34-42148 (Nov. 17, 1999).

<sup>12</sup> The SEC’s footnote repeats information in note 10, *supra*.

<sup>13</sup> The following is the SEC’s footnote:

*F.G. v. MacDonell*, 150 N.J. 550, 696 A.2d 697 (1997) (citing *In re Stroming’s Will*, 12 N.J. Super. 217, 224, 79 A.2d 492, 495 (App. Div.), *certif. denied*, 8 N.J. 319 (1951) (stating essentials of confidential relationship “are a reposed confidence and the dominant and controlling position of the beneficiary of the transaction”), and *Blake v. Brennan*, 1 N.J. Super. 446, 453, 61 A.2d 916 (Ch. Div. 1948) (describing “the test [as] whether the relations between the parties were of such a character of trust and confidence as to render it reasonably certain that the one party occupied a dominant position over the other and that consequently they did not deal on terms and conditions of equality”)).

<sup>14</sup> *In the Matter of Lazard Frères & Co. LLC*, SEC Rel. Nos. 33-7671, 34-41318 (Apr. 21, 1999).

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In contrast, a California court held that an underwriter did not have a duty to advise issuers as to the risks of a transaction, in part because:

This was an arm's-length relationship and it did not give rise to the affirmative disclosure and monitoring obligations on which [the issuers'] claims are premised.

and also because:

Plaintiffs have not shown that Goldman owed any duty to them outside the contracts between the parties. The underwriting contracts contained integration clauses.<sup>15</sup>

Indeed, many bond purchase agreements provide explicitly that the dealer is dealing with the issuer as a principal solely at arm's-length. Another form of contract adds that the dealer assumes no fiduciary duties to the issuer.<sup>16</sup>

Therefore, NAIPFA recommends: **Rule G-23 should be modified to require resigning dealers to provide specific advice to issuers that the fundamental nature of advice received from a financial advisor is different from that received from an underwriter and that the relationship between an issuer and underwriter and issuer should be considered at arm's-length.**<sup>17</sup>

Moreover, as discussed below, Rule G-23 protections are being circumvented due to the absence of specific guidance as to procedures for and documentation of resignations and issuer consents, by permitting financial advisory contracts to continue in effect despite resignations, and by the absence of a specific time period for resignation.

#### **4. Rule G-23 provides insufficient definition for the processes of resignation and consent**

NAIPFA believes that the crux of the Rule G-23 issue is that issuers are being denied independent financial advice, at a critical time when they seriously need impartial assistance and when many issuers are led to believe incorrectly by contentions and circumstances that they are

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<sup>15</sup> *Orange County Transportation Authority, et al., v. Goldman, Sachs & Co., et al.*, Case No. BC 170207 (Los Angeles County, CA Sup. Ct.) (Motion by Underwriter for Summary Judgment, March 26, 1998).

<sup>16</sup> We are aware that, despite such contractual provisions, and despite dealer protestations to the contrary, an underwriter nevertheless may enter, intentionally or inadvertently, into a relationship of trust and confidence that induces reliance by the issuer upon the dealer for advice in particular facts and circumstances. Courts have rendered judicial decisions affirming legal concepts regarding such relationships and fiduciary duties in several federal judicial circuits and the State of New York.

When dealers assure issuers that the dealers, in functioning as underwriters, will advise the issuers and act in the issuers best interests, they appear to create such relationships of trust and confidence and to induce issuer reliance upon the advice of the underwriters.

<sup>17</sup> See our example of suggested disclosure language at page 5, *supra*.



receiving such advice. That is occurring when dealers abandon their independent advisory responsibilities in order to pursue greater compensation as underwriters.

Because there are no MSRB standards for what constitutes a meaningful resignation, the following scenario is quite plausible:

At a meeting of an issuer's governing board, the dealer, acting as financial advisor, appears and proposes a plan for financing a capital project. The dealer intends to underwrite the issuer's securities issue, but does not so inform the issuer's governing board or other issuer officials at this time. The plan and proposed structure of the securities issue has particular appeal to the underwriting desk and sales capabilities of that specific dealer firm. The board and other issuer officials are not informed of those facts or that other pricing, structuring and marketing alternatives may exist.

The dealer then resigns from its advisory position in a letter to the issuer's staff or in a document that may be included in a large stack of documentation at closing. The resignation applies only to the specific transaction, leaving in place a continuing financial advisory contract between the dealer and the issuer. The issuer's governing board is not informed of the dealer's resignation, the existence of conflicts of interest, or the nature and extent of the conflicts. The issuer's staff is told only in a cursory manner that a conflict "may" exist, with no additional information, suggesting by material omissions that conflicts "may not" exist. The issuer staff is told that the dealer will place the interests of the issuer first.<sup>18</sup> The issuer's governing board may never know that the resignation occurred. The resigning dealer does not inform the board or other issuer officials of the identities of competing firms that may serve as advisors or underwriters on more favorable terms.

Subsequently, the dealer appears before the issuer's governing board at the time bond documents are approved and continues to advocate the transaction from the position of underwriter. The dealer's advocacy at least implies, or perhaps explicitly indicates, that the proposed transaction is the best one for the issuer. The governing board and other issuer officials, unaware of the significant nature of the change in roles and responsibilities of the dealer, perhaps in part because the dealer continues to have a

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<sup>18</sup> Likewise, because Rule G-23 does not require such disclosure in offering documents, there is no disclosure in the official statement that the dealer had served in an advisory relationship with the issuer; that the dealer has followed the abusive resignation procedures described in the example; that the dealer has a continuing financial advisory contract and relationship with the issuer; that the dealer has promised the issuer to place the interests of the issuer first; or that other conflicts exist. See the SEC's expression of concerns regarding the disclosure to investors of such conflicts of interest that are material in municipal securities issues. SEC Rel. No. 33-7049, 34-33741, 59 F.R. 12748, 12751 (March 9, 1994).

Many investors assume that underwriters offering and selling securities to the investors have fiduciary duties to the investors. If the underwriters have assumed duties to issuers during the course of the securities issues that conflict with the underwriters' duties to investors, then investors need to be so informed by the underwriters in an explicit manner in the disclosure documentation for those transactions, including the material nature and extent of those conflicts and the associated risks to investors. The cursory reference in Rule G-23 to disclosure to investors provides again inadequate guidance and permits obfuscated disclosure to investors.



financial advisory contract with the issuer, continue to place special reliance upon the dealer's advice as if that advice is rendered in the issuer's best interests.<sup>19</sup>

After the closing of the transaction, the dealer once again appears before the board, once again in the role of independent financial advisor, to report on the results of the financing. Due to the continuing financial advisory contract and state laws prohibiting interference in contractual relationships, competing firms are inhibited from giving the issuer the benefits of the analyses of those firms as to the dealer's performance and compensation as underwriter in the transaction.

In the foregoing example, the governing board has no means of knowing that the nature and character of the advice being received from the same professional is different from one appearance to the next. The board in the example is never advised that the dealer, as underwriter, has direct and actual conflicts of interest with the issuer related to the transaction or that the advice so received is no longer of a fiduciary standard. Variations of this include minor references in lengthy bond resolutions authorizing the financial advisory firm resignation and approving a bond purchase agreement for the dealer to underwrite the bonds and other low profile notice techniques.

Because financial advisory relationships tend to be long-term and because the resignation is required under Rule G-23 only for the specific transaction, absent specific and direct notices, explicitly approved by the governing board, it is unlikely that the issuer's policy makers will be aware of the fundamentally changed relationship. This is particularly true in the "revolving door" examples, such as that given above.

Various techniques are employed to obfuscate these changes from issuers. Those include long-term "evergreen" contracts that exist even during and after resignation periods; so called "investment banking consultant" agreements and even informal arrangements in which underwriters actually provide financial advice and induce reliance by issuers over an extended period with the expectation of receipt of compensation as underwriters, but do not call themselves "financial advisors;" provision of "free" advice in continuing relationships between

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<sup>19</sup> The Missouri Auditor's Report states at 15-16, in a context in which the Auditor had found that "In most private sales [in Missouri], the bond underwriters who purchased the bond issues also served as the financial advisor ... ."

Almost all of the local officials such as school superintendents, county administrators and city administrators we interviewed (who privately sold bond issues) said they placed their trust and reliance on their underwriters when issuing bonds. They accepted the initial noncompetitive interest rate quoted to them by their underwriter. As such, there was no negotiation between the local officials and the bond underwriters on what a fair market interest rate would be. The officials were not familiar with the potential savings through competition and relied on underwriters to manage their bond sales. In light of our results, several of these school superintendents and city administrators told us they would be more inclined to obtain competitive bids before issuing their next general obligation bonds.

The underwriters' advice reduced the likelihood of favorable interest rates by eliminating competition through private bond sales. As such, the Missouri bond market became virtually closed to competition, which has left taxpayers with excess costs. Had local officials obtained sound advice from an independent financial advisor, there is a greater possibility there would have been more competition and lower interest costs.



transactions for which dealers are compensated at the time of the next transaction; and other similar facts and circumstances.<sup>20</sup>

The recent revelations regarding the Texas Municipal Advisory Council's categorization of participants in Texas transactions indicates considerable confusion on roles and responsibilities among some market participants. As noted by the State Auditor, this confusion also exists in Missouri. To be meaningful, we believe that any resignation under Rule G-23 should be required to be effective for a specific period of time. We have recommended 180 days as constituting a brief, but sufficient, separation from underwriting to resumption of financial advisory duties. That period would permit communications from competing financial advisory and underwriting firms.

From a timing perspective, resignation is not practically required under the current version of Rule G-23 until the adoption of the bond documents immediately prior to bond pricing. Due to the time constraints of those facts and circumstances, this can leave issuers substantially disadvantaged in negotiating the terms and pricing of their transactions, and in seeking underwriting services and independent advice from other firms. We believe that notice of the resignation should be provided to allow the issuer sufficient time to obtain independent financial advice and review of the transaction then in progress and to consider other advisory and underwriting firms. At a minimum, a resignation should occur at a separate meeting prior to the adoption of the bond documents.

It is critical to keep in mind that a dealer resigning as financial advisor in order to underwrite an issuer client's securities continues to have a duty to render independent, affirmative advice to the issuer client until the resignation is complete (including among other things, the resignation's acceptance by the issuer).

Therefore, NAIPFA recommends the following: **A resignation as financial advisor for the purpose of underwriting the issuer's securities should be approved explicitly by the governing board of the issuer in an action separate, apart from and in advance of, the adoption of the bond authorizing resolution. Prior to that approval, the governing board should be fully informed of all material information as to the existence, extent and nature of the conflicts of interest.**

**Resignations should be timed to provide the governing board sufficient time, should the governing board so choose, to obtain alternative independent financial advice and to investigate the potential for alternative underwriting services prior to the transaction.**

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<sup>20</sup> Some underwriters engage in the hopelessly conflicting practice of telling issuers that the underwriters place the interests of issuers first, even though the underwriters cannot do so due to obligations to investors and even though the dealers are acting as arm's-length principals under their bond purchase agreements.

Under such circumstances, although the underwriters may have conflicting fiduciary obligations due to facts and circumstances of their own making, the courts have shown repeatedly that they will enforce fiduciary obligations to issuers. That has occurred in a number of federal courts and the State of New York.



**Resignations should be effective for a prescribed term, such as 180 days, from the date of completion of the offering.**

**5. Alternatives are available to preserve informed choice for issuers**

Contrary to assertions made by a few dealers in the press, NAIPFA does not recommend that broker/dealers be banned from providing financial advisory services. We believe in competition in the marketplace. Our concern is that issuers are being left without the benefit of independent, nonconflicted financial advice at a time when they seriously need it. The conflicts inherent when advisors abandon their clients to underwrite their debt are well-documented and self-evident.

We recognize that some issuers prefer to use broker/dealer advisors. We take note of two techniques used nationally that, in our opinion, mitigate the potential for Rule G-23 abuse in connection with continuing financial advisory contracts.

Some jurisdictions solicit and retain a pool of advisors and vary the advisors from transaction to transaction. To the extent a broker/dealer is a member of such a pool maintained by an issuer, and is selected to underwrite a transaction by that issuer, so long as the issuer is able to select another member of the pool to serve as financial advisor on the transaction being underwritten by the broker/dealer, we would not view that situation as requiring a resignation from a continuing financial advisory contract (i.e.: membership in the advisory pool), as outlined in this letter.

Secondly, some jurisdictions that use broker/dealers as their primary financial advisor also select alternate advisors. The alternate serves as advisor when the primary advisor seeks to provide underwriting, investment or swap services. So long as such independent advice is available to the issuer, we also do not view this as a situation requiring a resignation from a continuing financial advisory contract as outlined in this letter.

We do believe that there should be appropriate safeguards against two broker/dealers alternating between being advisor and underwriter on each other's transactions pursuant to arrangements or understandings between the two firms. Once again, there are self-evident conflicts in this situation. Such arrangements or understandings should be prohibited without full material disclosure to the issuers concerned with respect to the existence and extent of the conflicts of interest.

To be clear, NAIPFA's goal is to ensure that issuers have a fully-informed opportunity to enjoy materially complete, nonconflicted advice on each financing. Our goal is not to prohibit broker/dealers from serving as financial advisors.

**6. Existing Rule G-23 is no longer consistent with sound public policy**

In 1994, the Government Finance Officers Association adopted a recommended practice entitled, "Selecting and Managing the Method of Sale of State and Local Government Bonds."

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GFOA's policy states explicitly that issuers should, "Avoid using a firm to serve as both the financial advisor and underwriter of an issue because conflicts of interest may arise."

In 1997, GFOA adopted the recommended practice guidelines entitled, "Preparing Requests for Proposals to Select Financial Advisors and Underwriters." This guidance recommends a competitive process for the selection of underwriters. Naming the financial advisor as underwriter does not constitute a competitive process within the meaning of the GFOA guidelines.

California Government Code Section 53591 specifically prohibits firms who have served as a financial advisor to an issuer from participating in the negotiated sale of the issuer's bonds. The Code states:

No investment firm that has, or has had, a financial advisory relationship with respect to a new issue of bonds shall acquire as principal either alone or as a participant in a syndicate directly or indirectly, from the issuer all or any portion of the issue, or arrange for the acquisition or participation by a person controlling, controlled, by or under common control with the investment firm unless the issue is to be sold by the issuer at competitive bid and the issuer has, prior to the bid, expressly consented in writing to the acquisition or participation.

Thus, in California, advisor role switching in negotiated transactions is banned outright. Explicit approval from the issuer is required even for competitive sales.

At the time Rule G-23 was originally adopted by the MSRB, as indicated by the SDC rankings, most financial advisory services were provided by broker/dealers. Today, most broker/dealers have substantially reduced their financial advisory practices. Only a few firms actively pursue financial advisory engagements with the prior intent to underwrite their client's securities. The vast majority of firms have recognized this inherent conflict of interest on their own. In addition, there has been a proliferation of independent advisory firms providing choice for issuers.

In the regionalized market of the 1970's, and prior to the widespread availability of bond insurance, it may have been true that there was a limited demand for the bonds of small issuers, although frankly we doubt it. Today, in any case, as demonstrated every day on the pages of *The Bond Buyer*, there are many available market participants actively seeking to purchase securities, no matter what the size or credit quality of the issuers.

Today, any issuer that believes it must sell its securities to its financial advisor due to a lack of interest by other dealers in the market is being significantly misled, or is a victim of defective advice and performance by its financial advisor.

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## **Summary**

To reiterate, NAIPFA is not seeking to restrict issuer choice, not even with respect to whether dealers serving as financial advisors may be permitted to resign to serve as underwriters through use of appropriate procedures. We are seeking to update this 1970's-era Rule to reflect the market conditions and practices of today.

Our comments are focused on the following key issues:

**Disclosure:** Disclosure should be accurate, complete and timely so that issuer governing boards are able to evaluate the potential conflicts of interest and make an informed decision.

**Resignation:** Resignations should be made to prior to the approval of the bond documents to allow the issuer, should the governing board so choose, to obtain alternative financial advice or to consider alternative underwriting proposals. A resignation should be approved explicitly by the issuer's governing board after appropriate conflict disclosures, and to be meaningful, it should be for a specific term. Continuing contracts should be prohibited, with limited exceptions as outlined in this letter.

In the end, when issuers are allowed to make policy choices informed by truly independent, nonconflicted advice, and when issuers are protected from abuse, the market as a whole will benefit from a healthier and more competitive environment.

Yours very truly,

**NATIONAL ASSOCIATION OF  
INDEPENDENT PUBLIC FINANCE ADVISORS**

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