

# What to Expect From Your Underwriter

The Municipal Securities Rulemaking Board (MSRB) regulates the underwriters and advisors that state and local governments hire to bring new issues of municipal securities to market. The MSRB's Rule G-17, known as the "fair dealing" rule,<sup>1</sup> sets out specific requirements that an underwriter must follow when communicating to and working with a state or local government throughout the [new issuance process for municipal securities](#), particularly for negotiated offerings. State and local government officials should be aware of these requirements.

Rule G-17 requires an underwriter to deal fairly at all times with state and local government issuers and investors. In meeting this obligation, underwriters are expected to ensure that state or local government officials are aware of conflicts of interest well before becoming fully committed to completing the transaction with an underwriter, and that the issuer has the information required to be disclosed with sufficient time to take such information into consideration before making certain key decisions on the financing.

For more explanation about the newly expanded obligations of underwriters to their state and local government clients under MSRB Rule G-17, [view the MSRB's recorded webinar](#).

## Selecting an Underwriter

For state and local governments seeking an underwriter for new issues of securities through Requests for Proposals (RFPs) or Requests for Qualifications (RFQs), Rule G-17 offers important protections. Rule G-17 requires underwriters to:

- Be accurate and truthful in their responses to RFPs,
- Not omit material facts, and
- Not misrepresent their personnel's expertise with a particular type of financing in such responses.

<sup>1</sup> This document provides only a brief overview of the MSRB's interpretive notice on Rule G-17. Please refer to the MSRB's website for the full interpretive notice. The complete text of the rule and interpretations is available at <http://www.msrb.org/Rules-and-Interpretations.aspx>.



That same standard of accuracy, truthfulness and completeness applies to all statements and representations made to state or local governments by underwriters, whether made in writing or orally. Underwriters must have a reasonable basis for their statements and such statements must not be misleading.

## Role of the Underwriter

In a negotiated offering, underwriters are now required by Rule G-17 to provide a series of written disclosures to issuer personnel with authority to bind the issuer. State and local governments can expect an underwriter to specify the nature of its role and obligations in the underwriting process. Make sure your underwriter provides you these disclosures in writing and in a manner designed to make clear the subject matter of the disclosures and their implications:

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- An underwriter's primary role is to purchase securities for distribution in an arm's-length commercial transaction.
- Unlike a municipal advisor, an underwriter does not have a federal fiduciary duty to state or local government issuers and, therefore, is not required to act in the issuer's best interests without regard to its own financial or other interests.
- An underwriter has a duty to purchase securities from the issuer at a fair and reasonable price but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable.
- An underwriter reviews official statements in accordance with, and as part of, its responsibilities to investors under the federal securities laws.
- Any profit-sharing arrangements between an underwriter and investors, which can include arrangements to directly or indirectly split profits from the resale by the investor of securities sold to it by the underwriter;
- Whether the underwriter issues, purchases or trades credit default swaps related to your state or local government or one of your specific issues of securities, or baskets of credit default swaps in which your government or your securities represent more than two percent of the total principal amount of the basket; and
- Any incentives for the underwriter to recommend a complex municipal financing, such as compensation from a swap provider for recommending that swap provider.

If an underwriter fails to make any of the above disclosures about its role and obligations, it would be in violation of Rule G-17. An underwriter would also violate Rule G-17 if it discouraged a state or local government from using a municipal advisor or otherwise implied that hiring an advisor would be redundant because the underwriter can provide the same advisory services.

### Evaluating an Underwriter's Recommendations

The new disclosure requirements are designed to provide state and local government officials with material information you need to make an informed decision about an underwriter's recommendations. Rule G-17 requires underwriters to make certain disclosures about all actual or potential conflicts of interest, which may affect their recommendations of products, structures and pricing levels.

An underwriter must tell you about the existence of:

- Any payments an underwriter receives from or makes to third parties in connection with its underwriting of the new issue;
  - Disclosures are also required for similar payments in connection with a swap or reinvestment of bond proceeds.
- Any marketing arrangements with third parties;

### Considering Complex Financings

An underwriter that recommends a complex municipal security transaction — a financing that is structured in a unique, atypical or otherwise complex manner, such as variable rate demand obligations (VRDOs) and financings involving swaps or other derivatives — must help its state or local government client understand the material characteristics and risks of the transaction.

For example, if an underwriter recommends a VRDO, it should disclose:

- The risk of interest rate fluctuations;
- Any material risk of the potential inability of an issuer to replace a liquidity facility upon expiration; and
- Any material risk of potential shortening of the maturity schedule if bonds are not remarketed but instead are held as bank bonds.

Similarly, if an underwriter is recommending a swap in connection with a VRDO offering, it should disclose:

- Material financial risks, including market risk, credit risk, operational risk and liquidity risk;

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- Material financial characteristics of the swap, such as material economic terms, material operational terms and the parties' material rights and obligations; and
- The fact that there may be accounting, legal and other risks associated with the swap and that the issuer should consult with other professionals concerning such risks.

### Confirming an Underwriter's Compliance with Disclosure Requirements

State or local governments should expect to receive disclosure information from an underwriter at several points in the transaction.

- Disclosure of the arm's-length nature of an underwriting transaction are to be made in writing at the earliest stage of the underwriter's relationship with the state or local government.
- Disclosures concerning the role of an underwriter, compensation and conflicts of interests are to be made in writing when the underwriter is brought into the transaction, not later such as the signing of a bond purchase agreement.
- Disclosures concerning material financial characteristics and risks of complex financings and applicable routine financings, and newly identified conflicts of interest, are to be made in writing prior to execution of the bond purchase agreement.

An underwriter must request written acknowledgment of receipt of these disclosures from a state or local government official that has the authority to sign off on contracts with underwriters.

### Financial Aspects of Underwriting Transactions

Rule G-17 prohibits compensation that is excessively disproportionate to the nature of the underwriting and related services performed. Several factors can help state or local government officials determine whether an underwriter's compensation for a new issue is appropriate:

- The credit quality of the issue;
- The size of the issue;
- Market conditions;
- Length of time spent structuring the issue; and
- Whether the underwriter is paying the fee of the underwriter's counsel or any other relevant costs.

In addition to clarifying compensation guidelines, Rule G-17 also clarifies that the price paid by the underwriter to the state or local government must be fair and reasonable, taking into consideration all relevant factors, including the best judgment of the underwriter as to the fair market value of the issue at the time it is priced. In a negotiated underwriting, the underwriter has a duty under Rule G-17 to negotiate in good faith with the issuer. In a competitive underwriting, dealers must place bids that are bona fide and based on the dealer's best judgment of the fair market value of the securities.

If a state or local government issuer requests a retail order period, the underwriter must not knowingly accept an order that is inconsistent with the issuer's expectations. An underwriter must take reasonable measures to ensure that retail orders are bona fide. If an underwriter knowingly accepts an order that is framed as a retail order but which does not meet the issuer's requirements for retail, it would be a violation of Rule G-17.



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