

Brookings Institution 9th Annual Municipal Finance Conference

Discussion of “Conflicts of Interest in Municipal Advising and Underwriting” by Daniel G. Garrett



Presented by Lori Raineri
July 14, 2020

Some History

- ◆ October 19, 1978 - SEC approval of Rule G-23 as part of a package of rule amendments and new rules
 - ▶ Stated purpose:
 - "The purpose of the proposed rule changes is to codify basic standards of fair and ethical business conduct for municipal securities professionals."
 - With respect to Rule G-23 in particular, it was described as:
 - "Addresses certain aspects of the conduct of a municipal securities professional acting as a financial advisor or consultant to a state or local government unit. As a financial advisor, the municipal securities professional acts in a fiduciary capacity as agent for the governmental unit, assisting it in determining its debt structure, determining when and under what circumstances to market its securities, and preparing or assisting in the preparation of documents to be used in connection with the sale of its securities."

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More of What Was Said About G-23

- ◆ “The role and interests of a securities professional acting as a financial advisor to a governmental unit are significantly different from the role and interests of a securities professional acting as an underwriter or as a purchaser in a private placement.”

Yet More of What Was Said About G-23

- ◆ “For example, as agent for the issuer a financial advisor would normally seek to achieve the lowest possible interest cost for the issuer, while an underwriter, acting as principal for its own account, would normally want to establish yields which make the securities attractive for resale to others. Other marketing features, important from an underwriting perspective, may conflict with an independent determination of the same matters from the perspective of the issuer. If the underwriter has customers for large amounts of the securities to be issued, the underwriter may be influenced to advocate a larger issue than might otherwise be in the best interests of the issuer; conversely, an underwriter might advocate a smaller issue if its own customers’ interest is not strong. Maturities, redemption provisions, and remedy covenants are other facets of an issue with respect to which a municipal securities professional may be influenced to give different advise (sic), depending on whether the securities professional is acting as an underwriter or private placement purchaser of the securities, or solely as the issuer’s agent.”

G-23 Began as a Disclosure

- ◆ “This Board believes that this prima facie conflict is mitigated by competitive bid situations, where the existence of competition among underwriters for award of the securities tends to introduce an arms-length element into the establishment of the terms of the issue and the underwriting. In these situations, the Board believes that ordinary principles of agency law should apply. Thus in the Board’s view it is appropriate to require disclosure of the financial advisor’s intent to bid on the securities in a competitive sale, and to require the prospective underwriter to obtain the consent of the issuer to the dual role.”

All statements quoted are from 1978.

G-23 Became a Prohibition

- ◆ On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act became law.
- ◆ On May 27, 2011, the Securities and Exchange Commission amended Rule G-23 to prohibit a financial advisor from serving as an underwriter on the same offering of securities.
- ◆ On June 16, 2020, the Securities and Exchange Commission issued a “Temporary Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Registered Municipal Advisors”
 - ▶ Allows Municipal Advisors activities previously reserved for Dealers

Importance of the Research

- ◆ After almost 50 years of increasing regulation to limit and then prohibit what's been called a "prima facie" conflict of interest, this paper demonstrates that the conflict of interest resulted in a significant quantifiable cost by one measure – True Interest Cost, and this specific conflict of interest was eliminated by the 2011 prohibition added to Rule G-23.
- ◆ What's more important than research that confirms a national regulation affecting arguably every resident of the United States achieved one of its goals?

What's Next

- ◆ The paper assumes the behavior and motivations of market participants (issuers, advisors and underwriters).
 - ▶ Researchers could next pursue:
 - Identifying the actual behavior and motivations
 - Quantifying the impact of these missing factors
 - For issuers, advisors and underwriters
 - » Practices
 - » Goals and Constraints
 - » Skills and Resources