



National Examination Risk Alert

By the Office of Compliance Inspections and Examinations¹

In this Alert:

Topic: Duties of broker-dealers engaged in municipal underwriting.

Key Takeaways:

Examiners have observed that some broker-dealers have not maintained, nor did they require the maintenance of, adequate written evidence that they complied with their obligations under Securities Exchange Act Rule 15c2-12 and applicable Commission guidance regarding due diligence and supervision.

This Alert provides a number of examples of effective practices identified by the staff that evidence due diligence and supervisory review. These include the use of commitment committees; due diligence memoranda; outlines for due diligence calls; and recordkeeping checklists.

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Strengthening Practices for the Underwriting of Municipal Securities

Background

In the aftermath of the 2008 financial crisis and related economic turmoil, there is greater awareness of the financial vulnerabilities faced by state and local governments. Thus, a current focus of the Commission's National Examination Program ("NEP") is the potential risk to investors in the municipal securities markets. Due to these potential risks, the staff believes it appropriate to examine a range of broker-dealers' municipal securities underwriting activities.

In 1989, the Commission adopted Rule 15c2-12 ("Rule 15c2-12" or the "Rule") under the Securities Exchange Act of 1934 ("Exchange Act"), which sets forth certain broker-dealer obligations when participating in an underwriting.² The Commission also provided interpretive guidance about broker-dealers' obligations under the anti-fraud provisions of the federal securities laws to form a "reasonable basis" for offering new issues of municipal securities.³ Most recently, the

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² Exchange Act Release No. 34-26985 (June 28, 1989), 54 FR 28799 (July 10, 1989) ("1989 Adopting Release").

³ The "reasonable basis" requirement is often referred to as "due diligence," which is the term used in this Risk Alert. *See also* Exchange Act Release No. 33741 (March 9, 1994), 59 FR 12748 (March 17, 1994) ("1994 Interpretive Release") (reaffirming the Commission's interpretation of the obligations of municipal underwriters under the antifraud provisions of the federal securities laws).

Commission engaged in rulemaking in 2010 to amend Rule 15c2-12 in order to further enhance the quality and timeliness of information about municipal securities in the marketplace, and to update the Commission's interpretive guidance regarding the obligations of underwriters.⁴

Failure of a firm to comply with its due diligence obligation can lead to violations of the anti-fraud provisions of the federal securities laws, as well as Rule 15c2-12 and MSRB rules. Given these legal requirements, the Commission's NEP has been concerned about the level of due diligence and supervision carried out by underwriters in connection with offerings of municipal securities. Thus, the examination staff has engaged in, and is currently engaging in, various examinations of broker-dealers' municipal securities underwriting businesses so as to assess their compliance with applicable laws and rules.

Municipal Underwriter's Due Diligence Obligation

By participating in an offering, an underwriter makes an implied recommendation about the securities it is underwriting.⁵ By holding itself out as a securities professional and, especially in light of its relationship with the issuer, a municipal underwriter also makes a representation that it has a reasonable belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offering.⁶ Thus, if the broker-dealer fails to undertake efforts to form such a reasonable belief, it may violate the antifraud provisions of the securities laws.

More specifically, Rule 15c2-12 requires a municipal securities underwriter to, among other things, "obtain and review" a "deemed final" official statement, prior to bidding for or purchasing securities in connection with the offering and also to reasonably determine that an issuer, or obligated person, has undertaken in writing to provide the MSRB with certain specified continuing disclosures, prior to the time the underwriter purchases or sells municipal securities in an offering. In the 2010 Release, the Commission updated its interpretive guidance and emphasized that:

⁴ See Exchange Act Release No. 34-62184A (May 26, 2010), 75 FR 33100 (June 10, 2010) ("2010 Release"). The compliance date for the rule amendment was December 1, 2010.

⁵ See Exchange Act Release No. 34-26100 (Sept. 22, 1988), 53 FR 37778 (Sept. 28, 1988) ("1988 Proposing Release") at 37786.

⁶ *Id.* (and cases cited therein). See also 1989 Adopting Release. The Commission confirmed its interpretation of municipal underwriter responsibilities from the 1988 Proposing Release in the 1989 Adopting Release and made a few modifications, among other things, adding that "the presence of a credit enhancement does not foreclose the need for a reasonable investigation of the accuracy and completeness of key representations concerning the primary obligor." See, 1989 Adopting Release, 1989 WL 1113459 at p.*16. In addition, a municipal underwriter's due diligence obligation has been held to be primary and an obligation that cannot be delegated away (in terms of liability) to underwriter's counsel. See, *S.C. Nat'l Bank v. Stone*, 139 F.R.D.335,345 (D.S.C. 1991). Furthermore, MSRB Rule G-19 requires that "in recommending to a customer any municipal security transaction, a broker, dealer, or municipal securities dealer shall have reasonable grounds: (1) based upon information available from the issuer of the security or otherwise, and (2) based upon the facts disclosed by such customer or otherwise known about such customer, for believing that the transaction is suitable." See MSRB Rule G-19(c) (Suitability of Recommendations and Transactions; Discretionary Accounts).

- underwriters have a duty under the antifraud provisions of the federal securities laws, in both negotiated and competitively bid municipal securities offerings, to review the issuer's or obligated person's disclosures in a professional manner with respect to accuracy and completeness of statements made in connection with an offering;⁷
- it is important for underwriters to carefully evaluate the likelihood that an issuer or obligated person will comply on a timely basis with its disclosure undertakings;⁸ and
- underwriters should obtain evidence reasonably sufficient to determine whether and when annual filings and event notices, pursuant to an issuer's or obligated person's disclosure undertakings, were in fact provided, such as by a review of the municipal securities information repositories and the MSRB's Electronic Municipal Market Access ("EMMA") system.⁹

In the 2010 Release, the Commission also stated that sole reliance on an issuer will not suffice in meeting an underwriter's "reasonable basis" obligations.¹⁰

Supervisory Obligations

The responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme. In this regard, MSRB Rule G-27 requires broker-dealers to supervise the conduct of their municipal securities activities to ensure compliance with the rules of the MSRB and the applicable provisions of the Exchange Act and the rules thereunder. This supervision obligation would, of course, include supervision of compliance with Rule 15c2-12. MSRB Rule G-27, among other things, further requires broker-dealers to establish and maintain a system of supervision including written policies and procedures, annual examinations or testing of the system of supervision and a submission of a report to senior management, no less than annually, with a summary of the test results, and any additional or amended supervisory procedures to be adopted in light of such test results.

Section 15(b) of the Exchange Act also authorizes the Commission to impose sanctions on a firm or any person that fails to reasonably supervise a person subject to their supervision that violates the federal securities laws. Section 15(b)(4)(E) provides an affirmative defense against a charge of failure to supervise where reasonable procedures and systems for applying the procedures have been established and effectively implemented without reason to believe that such procedures are

⁷ See 2010 Release; 1988 Proposing Release, 53 FR 37778, at 37787.

⁸ See 2010 Release.

⁹ See 2010 Release. The Commission stated that an underwriter's reasonable belief should be based on its independent judgment, not solely on representations of the issuer or obligated person as to the materiality of any failure to comply with any prior undertaking. *Id.*

¹⁰ See 2010 Release at 33124.

not being complied with.¹¹ To rely on the defense in Section 15(b)(4)(E), a broker-dealer must develop a system for implementing its procedures that could reasonably be expected to prevent and detect securities law violations. However, establishing policies and procedures is not sufficient to discharge a person's supervisory responsibility. It is necessary to implement measures to monitor compliance with those policies and procedures and an appropriate system of follow-up and review if red flags are detected.¹²

Examination Purpose and Observations

The examinations have generally been designed to assess, among other things, municipal underwriters' compliance with their underlying due diligence and supervisory obligations, as well as the specific provisions of Rule 15c2-12 and MSRB Rule G-27.

In examining for these requirements, the examination staff is also looking for evidence that broker-dealers have: (i) created and maintained an adequate supervisory system and written policies and procedures setting forth the due diligence obligations of personnel carrying out the firm's responsibilities under Rule 15c2-12 (e.g., public finance bankers and their supervisory personnel), including their obligations consistent with Rule 15c2-12 and applicable Commission guidance, MSRB rules and the antifraud provisions of the federal securities laws; and (ii) created and maintained adequate written evidence of their performance of their obligations under Rule 15c2-12, MSRB rules and the antifraud provisions of the federal securities laws for purposes of their own internal reviews of compliance with these rules and regulations by internal audit and/or the compliance departments, as well as for Commission staff examinations.

In its examinations, the NEP staff has observed that some broker-dealers may not be engaging in the type or extent of due diligence activities discussed in the Commission's guidance on the subject. In addition, the NEP 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.¹³ Such an approach, however, makes it difficult for firms to demonstrate that they met their due diligence obligations and their duty to reasonably supervise with a view to preventing and detecting violations of the federal

¹¹ In addition, MSRB Rule G-27 sets forth a broker, dealer or municipal securities dealer's obligation to supervise its municipal securities activities and those of its associated persons and the requirements for a supervisory system, written supervisory procedures, internal inspections, review of correspondence, and a supervisory control system.

¹² See, e.g., Staff Legal Bulletin No. 17, Remote Office Supervision (March 19, 2004). See also, e.g., *Quest Strategies, Inc.*, Exchange Act Release No. 44935 (Oct. 15, 2001), *Consolidated Investment Services, Inc.*, Exchange Act Release No. 36687 (Dec. 8, 1994) at 6; *Gary E. Bryant*, Exchange Act Release No. 32357 (May 24, 1993).

¹³ While Rule 15c2-12 itself does not have an express record-keeping requirement, a firm may not be able to demonstrate compliance with that rule, and its supervisory responsibilities, without having evidence of its due diligence process and supervisory review thereof.

securities laws. This approach might lead to lax due diligence practices at a time when there are growing concerns over the fiscal well-being of some municipalities.

The staff reminds the industry that, separate from documentation of due diligence, the Commission has provided a non-exclusive list of six factors that it believes generally would be relevant in determining the reasonableness of an underwriter's basis for assessing truthfulness of key representations in a final official statement. These factors are:

- the extent to which the underwriter relied on municipal officials and other persons whose duties have given them knowledge of particular facts;
- the role of the underwriter (e.g., manager, syndicate member, selling dealer);
- the type of bonds being offered (general obligation, revenue, or private activity);
- the past familiarity of the underwriter with the issuer;
- the length of time until maturity of the securities; and
- whether the bonds are competitively bid or are distributed in a negotiated offering.¹⁴

To demonstrate compliance, underwriters of municipal securities should have adequate policies and procedures, including those relating to the firm's and its associated persons' compliance with its obligations.

Examples of Municipal Securities "Due Diligence" Practices, Policies and Procedures

The following are examples of practices identified by the staff that evidence some due diligence and supervisory review. Broker-dealers may, however, identify and implement other practices or controls that they believe are reasonably designed to meet their obligations under the federal securities laws, and the staff's observations described above.

Clear Explanation of Regulatory Requirements and Firms' Expectations

Some firms have fairly detailed written policies and procedures addressing the nature of the due diligence requirements under Rule 15c2-12, including a summary of applicable Commission guidance, and the firm's expectations as to how their personnel can develop a reasonable basis for offering any municipal new issue securities. These policies and procedures also describe supervisors' obligations in determining whether the diligence performed was adequate given the particular facts and circumstances. These supervisory policies and procedures make clear that that supervisors' determinations are most effectively made in advance of the offering, but after the review of the "deemed final" official statement. Some firms also develop and include in their written policies and procedures other processes whereby supervisors may provide business approval to submit materials in response to an issuer request for proposal or qualification, or make

¹⁴ 2010 Release at 91-92.

their initial business determination whether or not to proceed in the diligence and underwriting process.

Commitment Committees

Many broker-dealers have firm-wide, senior level commitment committees that review and approve various underwritings, including municipal securities underwritings. These commitment committees are in addition to “line of business” supervisory reviews, through a business level committee or otherwise. In advance of a scheduled commitment committee meeting, some firms require their personnel to submit a deal-specific set of materials to the committee for its review, prepared pursuant to written guidance and a template submission form. Such deal-specific committee submissions may consist of a due diligence memorandum describing the diligence that was done, including a list of the diligence calls in which firm personnel participated, and also certain portions of the “deemed final” official statement (e.g., the financial and risk disclosures) for review by supervisors and the Committee. Some firms require that business supervisors formally approve the commitment committee material before it is provided to the committees, or for business supervisors to provide the material to the committee, with the written instruction that such approvals, or submission of materials, is designed to evidence the supervisor’s review of the material and a determination that the level of diligence that was performed was adequate.

Such senior-level commitment committees can serve as an additional step in reviewing the diligence that was performed, with documentation that the transaction was approved, disapproved or was subject to additional diligence steps being performed. An added benefit of a firm-wide committee may be to instill discipline and rigor to the due diligence process and its documentation.

Some firms exempt certain underwritings from a firm-wide commitment committee process (e.g., based on credit ratings or commitment committee approvals of issuers previously reviewed by the committee within a certain period of time). In such cases, some firms require personnel to prepare the same or a similar form of submission as would be required for non-exempt underwritings, for provision to a committee chairperson, member (or an individual providing administration support to the committee), albeit without the need for a committee meeting. In this way, these firms’ policies and procedures reflect that due diligence and adequate supervision is required in respect of the specific offering and any changed circumstances, even though the firm as a matter of risk management has determined it is unnecessary to hold a formal commitment committee meeting.

Diligence “Checklists”

Some firms have also developed checklists to assist their personnel in recording the various diligence steps taken, including their review of the final or “deemed final” official statement and the results of an independent review of EMMA (and other data repositories for the time period prior to the development of EMMA). To evidence due diligence and supervisory review, such checklists may require substantial narrative describing due diligence steps that were undertaken. Such checklists may also include narrative responses relating to any past familiarity with the

issuer, and other factors relevant to forming a reasonable basis for offering new issue municipal securities.¹⁵

Due Diligence Memoranda

Some firms require public finance bankers to prepare a memorandum describing due diligence calls, issues noted and how they were resolved, as well as their review of the final or “deemed final” official statement. Such memoranda may be used in conjunction with checklists such as those described above, and as part of a submission to a commitment committee or other supervisory diligence review process.

Outlines for Due Diligence Calls

Underwriters’ counsel or issuer’s counsel often prepare outlines of disclosure issues to be discussed in due diligence calls in which the underwriters participate. Such outlines, particularly when accompanied by documentation of the responses to and resolution of such issues, may be helpful in evidencing an underwriters’ due diligence.¹⁶

On-Site Examination Activities

Some firms require their personnel to engage in various on-site examination activities, including meetings with municipal officials, visits to facilities and an examination of an issuer’s records and current economic trends and forecasts that bear on the ability of the issuer to pay its debt.

Recordkeeping Checklists

Some firms have developed recordkeeping checklists to assist personnel in maintaining records that evidence the due diligence that was performed, as well as specifying where such records should be maintained.

Conclusion

Effective policies and procedures, as well as a supervisory system reasonably designed to prevent and detect violations of the federal securities laws are required for a firm to meet its due diligence and supervisory obligations. The above examples could assist a firm in: evidencing how the firm is meeting its obligation to perform due diligence sufficient to support its implied representation that it has formed a reasonable belief as to the accuracy and completeness of the statements in the offering documents; and documenting its municipal underwriting efforts.

¹⁵ Some firms have stated that where a review of EMMA/other repositories is delegated to underwriters’ counsel, underwriters’ counsel will not, or customarily does not, provide any letter or other written evidence that it reviewed EMMA along with its findings. Other firms, however, have a review of EMMA as part of a diligence checklist or form of memorandum to indicate that a review was performed (through outside counsel or otherwise). This review includes noting any failures by the issuer to comply with its continuing disclosure undertakings, and suggesting how to proceed in light of any such failings. Supervisors may then be able to review any instance where an issuer may have failed to comply with its continuing disclosure undertakings, the nature of such failures and how then to proceed.

¹⁶ If the responses to the outline questions are not recorded, the staff would look to other processes for evidence that diligence was performed and was the subject of supervisory review.

The staff hopes that sharing observations from recent examinations is helpful to firms in strengthening their compliance and risk management programs, and welcomes comments and suggestions about how the NEP can better fulfill its mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. If you suspect or observe activity that violates the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.

This Risk Alert is intended to highlight for firms risks that the staff has indentified in the course of examinations regarding municipal securities offerings. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert may reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
