Commentary Time for a fresh look at Rule G-23 — Benefiting municipal issuers, taxpayers

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The Municipal Securities Rulemaking Board earlier this year announced that as part of its ongoing retrospective rule review, they are examining MSRB Rule G-23, "Activities of Financial Advisors." The purpose of the initiative is "to ensure MSRB rules are up-to-date, effective and reflective of the current reality of the municipal market."

Our market has evolved in the more than eight years since the MSRB last made significant changes to G-23, and participants should welcome the review.

BDA's Mike Nicholas

Rule G-23 governs some elements of municipal advisor activities. At the highest level, the current version, adopted in 2011, prohibits dealers from serving as municipal advisors and also as underwriters on the same transactions. The pre-2011 version of G-23 permitted such "role switching" under limited circumstances.

In a proposal filed with the Securities and Exchange Commission in 2010, the MSRB said that pre-2011 G-23 permitted "inherent conflicts of interest, which are not cured by the disclosure and waiver provisions of the rule." The MSRB also argued that the prohibition on serving as underwriter and FA on the same transaction should apply to both negotiated and competitive deals.

When Rule G-23 was last amended, there was a concern raised that the application on competitively bid transactions could seriously hurt issuers. Many commenters at the time, including some issuers, opposed how the amendments to Rule G-23 would prevent a firm that is acting as a financial advisor with respect to a competitively bid transaction to also submit a competitive bid as an underwriter.

The concern was — and still is — that some competitive issuers, especially small and infrequent ones, have relatively little underwriter coverage. If the issuer chooses one of the possible underwriter bidders on a competitive deal to serve as FA, the issuer will get one less bid at the auction. In some places in the country, that additional bid can be crucial.

Further, as long as the dealer submits a competitive bid on the same basis as other potential underwriters, the issuer can only be aided by the potential of an additional bid. That is, the traditional concern of a dealer acting as a financial advisor only to turn around and serve as the underwriter is not present in these competitively bid transactions.

The market data demonstrates how this issue is a problem for many state and local governments. The BDA has recently examined data from Ipreo on competitive new-issue municipal auctions. A very large percentage of competitive new issues are executed through the Ipreo platform, so it provides a good source of data.

As one might expect, there is a wide disparity in the number of bidders on competitive deals based on deal size. In 2018, for example, competitive municipal deals of between $50 million and 100 million had on average nearly nine bidders per deal, the largest average for the segments of the market at which BDA looked.

On the other hand, competitive deals less than $1 million in size had on average only 2.8 bidders per deal. Clearly if 2.8 is the average, many had fewer than that.

The picture isn't much better for slightly bigger transactions. Deals between $1 million and $5 million had an average of just 4.4 bidders, half the average for the $50 million to $100 million group. Deals between $5 million and $10 million had 5.6 bidders on average.

As this data shows, removing one bidder from smaller competitive deals impairs execution. Simply put, the more bidders at auction, the better execution issuers will see, and better execution translates directly into lower borrowing costs. Taking a potential underwriter out of the bidding mix because they were the issuer's choice for FA is not in the best interest of small issuers.

The BDA believes that in addition to removing the Rule's restriction on competitively bid transactions, the MSRB should consider simply eliminating Rule G-23 altogether.

Here's why.

The MSRB has now finalized a full set of rules governing the activities of municipal advisors including Rule G-42, a comprehensive rule governing many aspects of an MA's relationship with an issuer, including defining the MA's fiduciary responsibilities.

The current Rule G-23 was finalized less than a year after the enactment of the Dodd-Frank Act, which finally for the first time brought the previously unregulated nondealer FAs under federal oversight.

The operative provisions of Rule G-23 were adopted to address regulatory concerns that were dealt with much more comprehensively in Rule G-42, finalized in 2016. Now G-23 and G-42 are overlapping regimes, and Rule G-23 has lost its regulatory purpose. If any elements of G-23 need to be retained, they can be folded into Rule G-42.

Given that the Board initiated the Rule G-23 review earlier this year, we are likely to see action from the MSRB on this soon. The MSRB's focus on Rule G-23 is welcome. The Rule is overdue for review. The process gives the MSRB an opportunity to address long-standing issues that were controversial nine years ago and remain so today. We look forward to the conversation.

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