Ballard Spahr LLP

JANUARY 2023

Municipal Securities Regulation & Enforcement

2022 YEAR IN REVIEW AND LOOK AHEAD

As is widely known, the new issue market slowed down in 2022 due to a variety of factors, including rising interest rates, reduced institutional demand resulting from municipal bond fund outflows, inflation and recession fears, international tensions, and overall market volatility.

The slowdown in issuance was not, however, matched by the regulators, and in 2022, the Securities and Exchange Commission (SEC) brought several novel or otherwise notable types of enforcement actions. Most recently, the SEC announced a series of first-time settlements and one pending action against broker-dealers in limited offerings under SEC Rule 15c2-12. In June 2022, the SEC brought its first action for alleged violations of Regulation Best Interest (Reg BI). In September 2022, the SEC brought its first action against a broker-dealer for providing advice to a municipal entity without registering as a municipal advisor. These municipal advisor enforcement actions are in line with a risk alert issued by the SEC noting ongoing and pervasive non-compliance with federal municipal advisor regulations. In 2022, there were also multiple SEC actions charging financial professionals and school officials in connection with school district bond offerings.

The Municipal Securities Rulemaking Board (MSRB) engaged in a number of rulemaking efforts in 2022. Those efforts included extending the annual affirmation period for broker-dealers and municipal advisors under MSRB Rule A-12 to January 31 of each year, further extending temporary pandemic-related measures, applying Reg BI to bank dealers, clarifying the role of municipal advisors in obtaining CUSIP numbers in competitive offerings and proposing to reduce the time for trade reporting from 15 minutes to one minute or less.

Finally, environmental, social, and governance (ESG) disclosures, both as they relate to designation of bond issues and disclosure of risks, continue to be a key topic for issuers, investors, and regulators as the municipal securities market continues to seek guidance and clarity. In the second half of 2022, the SEC proposed two amendments related to ESG that could significantly affect how mutual and other funds approach their ESG investments in municipal bonds. The MSRB also responded to the comments it received on its 2021 ESG request for information. We expect ESG will continue to remain a focus of municipal market regulators and participants as the market settles on standards for the form and content of ESG disclosures in the primary and secondary markets.

IN THIS ISSUE:

Enforcement Actions – Year-End Review 2

Federal Action Against Regulators 4

Federal Legislation 4

MSRB Rulemaking – Year-End Review 4

SEC Risk Alert and Rulemaking – Year-End Review 6

Litigation Updates 6

ESG-Related Developments 6

Conclusion 7

Enforcement Actions – Year-End Review

FINRA Suspends Broker for Violation of MSRB Rule G-8 on Recordkeeping

On July 28, 2022, the Financial Industry Regulatory Authority (FINRA) suspended a former broker and investment advisor for 15 business days for violating MSRB Rule G-8 on recordkeeping for failures to identify the designated beneficiaries of 529 education savings plans. This rule requires brokers, dealers, and municipal securities dealers to keep current and accurate books and records, including customer account information. More specifically, MSRB Rule G-8 requires a record of customer information obtained pursuant to MSRB Rule G-19, which requires a reasonable basis to believe a recommended transaction is suitable for a customer based on the customer's investment profile, including investment objectives. For the purposes of MSRB Rule G-19, interpretative guidance from the MSRB states that information regarding the designated beneficiary of a 529 education savings plan is to be treated as information relating to a customer's investment objectives.

The former broker's firm implemented a new policy that prohibited the purchase of Class C shares in 529 plan accounts for young beneficiaries, unless the firm granted an exception. Following the effective date of this policy, several of the broker's customers decided to close existing 529 plan Class C share accounts for young beneficiaries and to open new 529 plan Class C share accounts. However, for the required firm forms to establish the new 529 plan Class C share accounts, the broker identified related adults rather than the intended young beneficiaries for such accounts as the account beneficiary. Those actions caused the new accounts to bypass the firm's review under the new 529 plan policy and caused inaccurate books and records for the firm. A copy of the letter of acceptance, waiver, and consent can be found here.

SEC Charges Underwriters for Failure to Meet Requirements for Limited Offering Disclosure Exemption

On September 13, 2022, the SEC announced enforcement proceedings against four municipal market underwriters for alleged violations of municipal bond offering disclosure requirements under Rule 15c2-12 of the Securities Exchange Act of 1934, as amended (the Rule). The Rule establishes certain requirements in connection with primary market and continuing disclosures to be provided to investors, unless an exemption applies. Three of the other underwriters settled with the SEC while charges remain pending against the remaining underwriter.

Under the terms of the Rule, a limited offering exemption is available for offerings sold in $100,000 authorized denominations if the securities are sold to no more than 35 persons who the underwriter reasonably believes (i) have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the investment (the sophisticated investor clause) and (ii) are not buying the securities for more than one account or with a view to distributing the securities (the investment purpose clause).

According to the SEC, the underwriting firms sold new issue municipal securities in primary offerings intended to meet the limited offering exemption to broker-dealers and investment advisers without a reasonable belief that the entities were making purchases for their own accounts or without a view to distribute the securities, as required by the investment purpose clause. The SEC asserted that, because the underwriters failed to ascertain for whom the broker-dealers and investment advisers were purchasing the securities, the underwriters were unable to form a reasonable belief that the broker-dealers and investment advisers were purchasing the securities for investors who possessed the necessary knowledge and experience to evaluate the investments, as required by the sophisticated investor clause.

The SEC's pending complaint against the underwriter who did not settle provides more details about the alleged violations. In that complaint, the SEC observed that some broker-dealers and investment advisers purchasing securities in the primary offerings from the underwriter shortly thereafter resold the securities to multiple brokerage customers or allocated the securities to multiple advisory clients. The SEC alleged that the underwriter "made no inquiry to determine if those entities were buying on behalf of their customers and/or clients and, if so, whether such investors met the exemption criteria." The SEC argues that the underwriter

"did not reasonably believe the broker-dealers were buying the securities for their own accounts because the broker-dealers that were buying the securities were in the business of servicing brokerage customer accounts" and also "did not reasonably believe the investment advisers were buying the securities for their own accounts because these investment advisers were in the business of managing accounts for their advisory clients."

The SEC notes in the pending complaint that the underwriter did not inquire whether the broker-dealers or investment advisers were purchasing on behalf of their customers or clients. Further, in cases where the broker-dealers or investment advisers may have been purchasing on behalf of their customers or clients, the SEC states that the underwriter "neither requested nor received information from the broker-dealers [or investment advisers] about: how many customers [or clients] would receive the securities; how much each customer [or client] was investing; each customer's [or client's] level of financial experience; or whether each customer [or client] was buying for a single account." The SEC concluded that, without this information, the underwriter could not have formed the requisite reasonable belief that the broker-dealers or investment advisers, or the customers or clients on whose behalf they may have been buying, were sufficiently sophisticated and buying for their own account, as the limited offering exemption requires. The SEC also alleged that the underwriter violated MSRB Rule G-17, which requires fair dealing, by deceptively representing to municipal market issuers that it complied with the limited offering exemption requirements.

While the pending complaint identifies certain matters that the SEC believes underwriters should consider in determining compliance with the limited offering exemption requirements, the SEC provides no guidance on how such inquiries should be undertaken or whether investor letters can be used for this purpose. As a matter of practice, investor letters are often used by municipal market underwriters to confirm the sophisticated status and investment intent of municipal securities purchasers.

The SEC further alleges that the underwriting firms also violated MSRB Rule G-27, which requires municipal market underwriters to put in place sufficient supervisory policies and procedures to ensure compliance with federal securities laws.

The four underwriters who settled with the SEC agreed to disgorgement and penalties ranging between $100,000 and $300,000. The SEC stated in its news release that it has started investigating whether other firms are properly relying on the limited offering exemption. The SEC is encouraging firms that believe they may have not complied with the exemption requirements to self-report possible violations to the SEC. The SEC did not provide a form for self-reporting or standard settlement terms, or articulate why self-reporting would result in more favorable action from the Division of Enforcement. Copies of the orders and complaint can be found here.

SEC Follow-up Action Against Fifth Underwriter

On December 21, 2022, the SEC announced a fifth action, similar to those described above, against an underwriter for alleged violations of municipal bond offering disclosure requirements under SEC Rule 15c2-12 because the transaction did not meet the requirements of the limited offering exemption, discussed in detail above. The underwriter settled with the SEC, agreeing to a cease-and-desist order from future securities law violations as well as a payment of $81,362 in disgorgement plus prejudgment interest of $16,961, and a $100,000 civil money penalty. A copy of the order can be found here. This fifth action against an underwriter indicates the SEC's continued enforcement focus on the limited offering exemption.

SEC Charges Broker-Dealer for Failure to Register as Municipal Advisor

On September 14, 2022, the SEC, for the first time, charged a broker-dealer with providing advice to a municipal entity without first registering a municipal advisor. The SEC's order alleged that a broker-dealer advised a city on the purchase of fixed-income securities with municipal bond proceeds between September 2017 and February 2019. The SEC further alleged that the broker-dealer did not have adequate supervision measures in place. A copy of the cease-and-desist order can be found here.

Federal Action Against Regulators

At the same time as the SEC continues its push for greater disclosure, at least one news organization has sued the SEC, seeking additional information relating to the SEC's approval of FINRA rule changes to underwriter reporting requirements, which approval was provided despite concerns raised by underwriters regarding a New Issue Reference Data Service to be provided by FINRA, similar to the MSRB-mandated New Issue Information Dissemination Service (NIIDS) operated by the Depository Trust & Clearing Corporation (DTCC). Specifically, Bloomberg LP had commented that FINRA did not provide information regarding how much the data service would cost to build and maintain and the extent to which such costs would be passed along to market participants. The court found that the SEC's approval of FINRA rule changes was arbitrary and capricious because the SEC did not provide a "reasoned explanation" that responded to the cost concerns raised by Bloomberg–in particular, the SEC "did not provide a reasoned response to Bloomberg's comments that FINRA failed to quantify the direct and indirect costs of its proposed data service (or explain why certain costs could not be quantified), and failed to explain how the costs incurred for building the service will be paid if the [SEC] disapproves FINRA's proposed fee structure in subsequent proceedings." The court remanded the case to the SEC for reconsideration but did not vacate the SEC's approval. The case is *Bloomberg L.P. v. SEC*, 45 F.4th 462 (D.C. Cir. 2022). This case is significant as it affirms that self-regulatory organizations (whether FINRA or the MSRB) and the SEC must sufficiently address the concerns raised by market participants prior to making regulatory changes.

Federal Legislation

Financial Data Transparency Act

The Financial Data Transparency Act of 2022 (FDTA) was enacted into law in December 2022 as part of the 2023 National Defense Authorization Act (NDAA). The FDTA mandates a broad range of financial and other information submitted to financial regulators, including by state and local governmental issuers and non-profit and other obligated persons, to be reported in a standardized format as structured data to ensure uniform reporting across all types of entities. The FDTA raised concerns for municipal market issuers given the estimated $1.5 billion cost for municipal issuers to implement the financial reporting standards. Lobbying efforts by organizations such as the Government Finance Officers Association, the National League of Cities, and the U.S. Conference of Mayors were unsuccessful in removing the FDTA from the NDAA, but some changes were made to the final version of the FDTA in response to their concerns.

As part of a broader financial markets initiative, the FDTA will require the SEC to develop data standards for information submitted to the MSRB related to the municipal bond market, including financial reporting by municipal issuers and obligated persons. Reporting entities will be required to submit data meeting a number of technical standards, including rendering the data in fully searchable and machine-readable form. The SEC is required to consult with market participants in designing the standards and is subject to certain guardrails established by Congress to restrict the SEC and MSRB from undertaking actions inconsistent with the Tower Amendment. The SEC will be required to issue a rule on the new reporting standards within four years.

See our White Paper: Structured Data is Coming to the Municipal Securities Market–Now What?, available here, for a detailed discussion of the expected impact of and implementation process for the FDTA for municipal market participants.

MSRB Rulemaking – Year-End Review

Proposed Changes to MSRB Rule G-14 Regarding Trade Reporting

On August 2, 2022, the MSRB issued a request for comment on proposed amendments to Rule G-14 that would require municipal securities transactions to be reported within one minute of the time of trade, rather than the current 15 minute requirements. The proposal was issued in coordination with a similar proposal by FINRA with respect to debt securities of corporate issuers, federal agencies, government-sponsored enterprises and the U.S. Treasury. The MSRB has received over 50 comments on the request for comment expressing significant concerns over the proposal, including concerns about the impact the new requirement would have on both retail and institutional

investors as well as smaller broker-dealer firms, and on the failure to properly undertake a meaningful cost-benefit analysis. The request for comment can be found here.

Changes to MSRB Rule G-3 Regarding Continuing Education for Dealers

On August 30, 2022, the MSRB filed with the SEC a proposed rule change consisting of amendments to MSRB Rule G-3 on professional qualification requirements. The MSRB proposed amending the MSRB's continuing education (CE) program requirements for brokers, dealers, and municipal securities dealers to align with FINRA's recent amendments to Rules 1210 and 1240. The MSRB proposed (i) transitioning the Regulatory Element of CE to an annual requirement for each dealer qualification category; (ii) extending the Firm Element component of CE for dealers to all registered persons of dealers; and (iii) permitting maintenance of professional qualifications for dealers after termination of registration. The rule changes took immediate effect on September 7, 2022. The rule change does not impact the CE obligations for municipal advisors. An explanation and the text of the amendments can be found here.

Changes to MSRB Rule G-34 Regarding CUSIP Numbers for Competitive Offerings

On August 25, 2022, the SEC approved amendments to MSRB Rule G-34 on CUSIP Numbers, New Issue, and Market Information Requirements. The amendment confirmed the municipal advisor's role in obtaining CUSIP numbers in competitive offerings and streamlined certain language in the rule. The amendment confirming the municipal advisor's role was adopted after the MSRB had previously announced that it would eliminate such obligation. An explanation and the text of the amendments can be found here.

Extension of Annual Affirmation Period and Changes to Form A-12 Registration Requirement

On December 13, 2022, the MSRB amended MSRB Rule A-12 to extend the annual affirmation period for broker-dealers and municipal advisors through January 31 of each calendar year and permit regulated entities to update optional information on Form A-12 during the annual affirmation period, rather than 30 days of a change. The changes are operational as of January 1, 2023. An explanation and the text of the amendments are available here.

Proposed Amendments to MSRB Rule G-32 on Disclosures in Connection with Primary Offerings

On November 9, 2022, the MSRB published a notice requesting comments on draft amendments to MSRB Rule G-32 to clarify and streamline the timeline for underwriters to submit information on Form G-32 to the MSRB. The draft amendments would not alter the data collected on Form G-32 (which includes, among other items, the issuer name, issue description and CUSIP numbers, principal amounts and initial offering prices or yields for each maturity), only the timing for submission of the data. Specifically, an underwriter would be required to initiate certain data elements on Form G-32 prior to the end of the day of first execution of the formal award and complete any outstanding data elements by the end of the closing date. An underwriter would fulfill the obligation to initiate Form G-32 by creating the form in EMMA Dataport and populating it with the applicable information, but would not be required to submit the completed Form G-32 until the end of the closing date. The MSRB requested comments on these amendments be submitted no later than January 17, 2023.

MSRB Announced Future Proposed Amendments to Municipal Advisor Advertising

On September 15, 2022, the MSRB voted to amend MSRB Rule G-40, on advertising by municipal advisors, to permit municipal advisors to use testimonials in advertisements. The proposed amendments to MSRB Rule G-40 are to be subject to limitations aligned with analogous requirements under the SEC's revised Rule 206(4)-1, on investment adviser marketing. A proposed rule change was anticipated to be filed with the SEC before the end of the calendar year. As of December 26, 2022, the proposed rule change had not been filed with the SEC. The intent of the rule change is to conform advertising standards for municipal advisors to those promulgated by the SEC for investment advisors.

SEC Risk Alert and Rulemaking – Year-End Review

Municipal Advisor Risk Alert

On August 22, 2022, the SEC's Division of Examinations (the Division) released a Risk Alert to notify municipal advisors of key compliance issues. The alert follows the Division's 2017 release and reiterates old concerns as well as raises new ones. While the 2017 release addressed deficiencies found in the areas of municipal advisor registration, recordkeeping, and supervision, this latest alert adds client disclosure concerns to the list of most frequently observed compliance failures. The Division warned that it intended to have a sharper focus on core standards of conduct and duties required of municipal advisors. Read our legal alert here.

Proposed Regulation Best Execution

On December 14, 2022, the SEC proposed Regulation Best Execution, which would establish an SEC rule—similar to the existing MSRB and FINRA rules—requiring broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to comply with the SEC's proposed best execution standard. The proposed rule also would require broker-dealers policies and procedures to address execution decisions for customer orders and conflicted transactions. Broker-dealers would further be required to document order flow payments. Broker-dealers under the proposed rule must review the quality of customer order executions, at minimum, quarterly and their policies and procedures, at minimum, annually. The SEC staff has stated that it views Regulation Best Execution as operating in addition to existing MSRB and FINRA best execution rules. A copy of the proposed rule can be found here.

Litigation Updates

Litigation Update – Whistleblower VRDO Lawsuits

Johan Rosenberg, a Minnesota-based municipal advisor working through his entity Edelweiss Fund LLC, filed a series of lawsuits in several states in 2015 alleging that 16 banks colluded to set the interest rates artificially high on variable-rate debt issued by states (VRDOs), potentially leading to profits at the expense of taxpayers. Rosenberg claims to have discovered a "robo-resetting" scheme in which the defendant banks assembled large groups of the VRDOs and set their rates, without taking into account the characteristics of the securities. Rosenberg's lawsuits ague that these actions to inflate the variable rates constitute violations of the remarketing agreements binding the banks to remarket the VRDOs at the lowest possible rates. The lawsuits were previously described in our 2020 Mid-Year Newsletter and 2019 Year-End Newsletter.

With respect to the lawsuit filed in New York, in July 2022, a judge granted the request of the defendant banks to seek materials related to swaps in discovery. The main thrust of the argument by the banks to do so is that the municipal issuers either were not harmed or were harmed less by inflated rates by entering into swaps that permitted them to exchange the variable rate payment for a fixed payment under the swap agreement.

ESG-Related Developments

MSRB Publishes Summary of Responses to Request for Information on ESG Practices in the Municipal Securities Market

As discussed in our 2021 Year-End Report, on December 8, 2021, the MSRB issued a request for information on ESG practices in the municipal securities market. The deadline for the comments was March 8, 2022, and the MSRB received 52 submissions from issuers, individuals, and industry groups. On August 9, 2022, the MSRB published a summary of the responses that it received and highlighted three broad themes of the comments: (1) the evolving nature of ESG practices in the municipal securities market; (2) challenges associated with ESG integration in the municipal securities market; and (3) opportunities to improve market transparency through the MSRB's EMMA website.

With respect to the first theme, the MSRB described how many commenters noted that market-based solutions were still emerging and premature regulatory action might inhibit development of best practices given the evolving ESG practices in the municipal securities market. One of the key challenges for ESG integration in the municipal securities that commenters described was the lack of widely accepted ESG standards and practices. Additionally, the MSRB described concerns from commenters regarding compliance with existing

regulations as ESG practices evolve. The summary also described recommendations from commenters to improve market transparency around ESG through changes to the MSRB's EMMA website. Our August 19, 2021, municipal securities white paper entitled "ESG Disclosure in Municipal Offerings," as part of our Municipal Securities Disclosure Series, discussed many considerations related to ESG-labeled bonds and related disclosure.

SEC's Mutual Fund ESG Proposals and Impact on the Municipal Bond Market

As highlighted in our September 2022 legal alert, on May 25, 2022, the SEC proposed two amendments related to ESG that can provide clues to market participants as to any future regulations of ESG in the municipal bond market. The ESG Fund Proposal would add specific disclosure requirements for funds and advisers regarding ESG strategies, including the implementation of a tabular disclosure approach for ESG funds to permit investors to easily compare ESG focused funds. Additionally, this proposal requires certain environmentally focused funds to disclose greenhouse gas emissions related to their portfolio investments. The Fund Names Proposal would enhance the current requirement for certain funds to adopt a policy to invest at least 80 percent of their assets in accordance with the direction of the fund's name. While not directly applicable to the municipal market, there could be impacts related to these proposals. Funds that take ESG matters into account for their investment decisions may develop more structured criteria regarding the assessment of ESG factors, which could result in less flexibility from the funds toward municipal issuers regarding investment decisions and increased expectations with respect to the ESG related disclosure to be provided by municipal issuers.

Conclusion

In 2023, we expect additional ESG-related regulatory developments, including the potential approval by the SEC of final rules for the ESG Fund Proposal and Fund Names Proposal, and potential widespread rulemaking encompassing cybersecurity and other regulatory changes. Additionally, the growing backlash to ESG highlighted in our 2022 Mid-Year Newsletter is unlikely to abate. The MSRB has stated that a major emphasis for the MSRB in 2023 will be a coordinated review with the SEC and FINRA of fixed income market structure. We also expect more SEC rulemaking to expand investor protections, potentially in digital engagement on financial services platforms, exchange-traded products, and conflicts of interest in securitizations, as well as SEC enforcement activity related to the limited offering exemption under federal securities laws, and further addressing duties of municipal market professionals.

Kimberly D. Magrini, *Public Finance*
Municipal Securities Regulation and Enforcement
magrinik@ballardspahr.com | 215.864.8365

William C. Rhodes, *Public Finance*
Municipal Securities Regulation and Enforcement
rhodes@ballardspahr.com | 215.864.8534

Teri M. Guarnaccia, *Public Finance*
Municipal Securities Regulation and Enforcement
guarnacciat@ballardspahr.com | 410.528.5526

Ernesto A. Lanza, *Public Finance*
Municipal Securities Regulation and Enforcement
lanzae@ballardspahr.com | 202.777.6053

John C. Grugan, *Litigation*
Municipal Securities Regulation and Enforcement
gruganj@ballardspahr.com | 215.864.8226

M. Norman Goldberger, *Litigation*
Municipal Securities Regulation and Enforcement
goldbergerm@ballardspahr.com | 215.864.8850

Tesia N. Stanley, *Litigation*
Municipal Securities Regulation and Enforcement
stanleyt@ballardspahr.com | 801.531.3036