

Corporate & Financial Weekly Digest

March 23, 2012 by [Daren R. Domina](#)

SEC Staff Issues Risk Alert on Municipal Securities Underwriting Practices

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On March 19, the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations released a National Exam Risk Alert regarding the enhancement of municipal securities underwriting practices. In the Risk Alert, the staff of the SEC's National Exam Program (NEP staff) observes that broker-dealers may not be engaging in sufficient due diligence practices and provides examples of effective practices.

The Risk Alert reminds broker-dealer underwriters of their due diligence and supervisory obligations under various laws and rules. SEC Rule 15c2-12 under the Securities Exchange Act of 1934 (Rule 15c2-12) sets forth broker-dealer obligations when participating in an underwriting, such as providing continuing disclosure information of annual financial information and material event notices. In addition to Rule 15c2-12, the SEC has provided interpretive guidance regarding broker-dealers' obligations under the anti-fraud provisions of the federal securities laws, which require broker-dealers to form a "reasonable basis" for offering new issues of municipal securities. By participating in an offering, a municipal underwriter is deemed to be making an implicit 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. Sole reliance on an issuer's representations will not suffice in meeting an underwriter's obligations.

NEP staff reminds broker-dealers that the SEC 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.

In addition, broker-dealers have the responsibility to supervise municipal securities activities to confirm compliance with SEC requirements and the rules of the Municipal Securities Rulemaking Board (MSRB). Generally, broker-dealers must establish and maintain a system of supervision including written policies and procedures, annual examinations or testing of the system of supervision and submission of annual reports to senior management. Broker-dealers also must implement measures to monitor compliance with those policies and procedures and an appropriate system of follow-up and review if red flags are detected.

NEP staff has been concerned about the level of due diligence and supervision carried out by underwriters in connection with offerings of municipal securities. As a result, NEP staff has been looking for evidence that broker-dealers have:

- created and maintained an adequate supervisory system and written policies and procedures setting forth the due diligence obligations of personnel carrying out responsibilities under Rule 15c2-12, applicable SEC guidance, MSRB rules and the anti-fraud provisions of the federal securities laws; and
- created and maintained adequate written evidence of their performance of such obligations for purposes of internal compliance reviews by internal audit and/or the compliance departments, as well as for SEC staff examinations.

While conducting examinations, NEP staff observed instances where municipal underwriters did not maintain (nor did they require the creation and maintenance of) adequate written evidence that they complied with their due diligence obligations. The SEC notes that such an approach makes it difficult for firms to demonstrate that they have fulfilled their due diligence obligations and their duty to reasonably supervise with a view to preventing and detecting violations of the federal securities laws.

Due to a concern over potentially lax due diligence and supervisory practices, NEP staff also provided the following examples of effective practices:

- Maintain written policies and procedures that address regulatory due diligence requirements and the firm's expectations as to how personnel can develop a reasonable basis for offering any municipal new issue securities;

- Create a senior-level commitment committee that reviews and approves deal-specific sets of materials in municipal securities underwritings;
- Create due diligence checklists to evidence due diligence and supervisory reviews;
- Ask underwriters' counsel or issuer's counsel to prepare outlines of disclosure issues to be discussed in due diligence calls;
- 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;
- Have personnel 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; and
- Develop 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.

NEP staff noted that these examples could assist a firm in evidencing how the firm is meeting its obligation to perform sufficient due diligence and documenting its municipal underwriting efforts.

While the alert does not have the same impact as an official SEC pronouncement, broker-dealers should be aware that regulators will look to it in analyzing broker-dealer compliance with applicable rules and their obligations in municipal securities underwritings. Click [here](#) to read the Alert.

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