

H.R. 2827—Potential Loss of Important Protections for Municipal Securities Issuers

by Robert Doty

On October 1, 2012, provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, enacted in 2010 (the "Dodd-Frank Act") became effective. The Dodd-Frank Act provides significant new protections to state and local governments (called "municipal entities" in the Act) through the regulation of "municipal advisors." The Dodd-Frank Act also re-structured the Municipal Securities Rulemaking Board ("MSRB") so that it now has a majority of public members (including three issuers, currently) and a mission to protect issuers, as well as investors.

In general, "municipal advisors" were defined in the Act to include financial advisors, swap advisors, and others advising municipal entities with respect to the issuance of securities, derivative products, and certain investments. The Act provides that municipal advisors have a fiduciary duty to municipal-entity clients the advisors advise. The Act also provides for the MSRB to regulate municipal advisors by means of qualifications testing, establishment of professional standards, implementation of the statutory fiduciary duty and continuing education requirements, and in other respects. Previously, many municipal advisors were entirely unregulated, and others who were subject to regulation were not regulated significantly in their municipal advisor roles.

The Securities and Exchange Commission ("SEC") undertook to define the term "municipal advisor," issuing a proposed definition in December 2010. The SEC's proposal created a great controversy. This stemmed primarily from the SEC's inclusion of appointed officials of municipal entities within its proposed definition (elected officials are excluded by the statute). Over 1,000 comments were sent to the SEC regarding its interpretive action. The SEC has not yet finalized its definition, but when the SEC finally acts, many anticipate it will revise its proposal significantly in response to these comments.

Not only state and local governments disputed the SEC's definition: commercial banks complained that the interpretation would include tellers and other staff members at local bank branches who might advise municipal officials regarding the placement of funds in deposit or savings accounts. Investment banks complained that, when they serve as underwriters, even when they "advise" state and local governments in the underwriting capacity, they should not be held to the standards applicable to municipal advisors (especially the fiduciary standard).

Some background may be helpful. The fiduciary duty is one of the major benefits extended to municipal entities by the Dodd-Frank Act. Briefly, the fiduciary duty has two principal components: (1) a duty of care; and (2) a duty of loyalty. The duty of care, essentially, is a requirement that municipal advisors provide advice to their municipal-entity clients in accordance with prudent industry standards. The duty of loyalty requires municipal advisors to disclose, to their clients, conflicts of interest to which the municipal advisors may be parties, and even to avoid serious conflicts of interest entirely. The duty of loyalty also requires municipal advisors to provide advice in the best interests of their clients (in other words, not in the advisors' interests), and to speak affirmatively on matters within the scope of employment of the advisors. Parties who are not fiduciaries generally do not have a duty to speak affirmatively. Rather, while parties who are not fiduciaries must speak truthfully when they do choose to speak, they have an option to remain silent rather than being obligated to warn against unsound transactions.

By way of contrast between municipal advisors and underwriters, and to identify key issues that now are at stake, underwriters (as opposed to dealers and nondealers serving as municipal advisors) are not subject to the fiduciary duty. For example, a recent interpretation by the MSRB of its due care rule—Rule G-17—now requires underwriters, among other things, to make the following disclosures to municipal issuers (quoting the interpretation):

> (i) Municipal Securities Rulemaking Board Rule G-17 requires an underwriter to deal fairly at all times with both municipal issuers and investors;
>
> (ii) the underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer;
>
> (iii) unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests;
>
> (iv) the underwriter has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable; and

Continued on page 37

commit any chargeable offense, or, at most, a misdemeanor; the officers did not reasonably believe Nelson or any of his companions posed a threat (no one in their group was throwing things or engaging in any other threatening behavior); and there was no failure on their part to comply with orders (even assuming they had heard the order to disperse, "this single act of non-compliance, without any attempt to threaten the officers or place them at risk, would not rise to the level of active resistance"). Finally, the giving of a warning or the failure to do so was also a factor to be considered. The force used "resulted in substantially more than a minimal intrusion and was not justified by the governmental interest in dispersing a group of student partygoers who could most likely be dispersed by less forceful means. We therefore conclude that the force used by the government was unreasonable and resulted in a violation of the Fourth Amendment."

The involved officers were "well aware" of the risks that accompanied the use of pepperball projectiles, particularly when fired at a distance well beyond that approved under their guidelines, and it had been clearly established prior to the time of Nelson's shooting that the intentional application of force which terminated an individual's freedom of movement resulted in a seizure. On whether the law was sufficiently clearly established that a reasonable officer would have been on notice that the use of pepperball projectiles, directed towards Nelson and his friends was unreasonable under the circumstances, the court held that it was. Although there was no binding precedent that had specifically addressed the use of pepperball projectiles and the pepperball projectile was a relatively new mechanism by which a combination of concussive impact and chemical irritants could be applied to individuals by law enforcement, "the type of pain inflicted [was] the same or greater than that caused by weapons that this court has already recognized [as] constitut[ing] excessive force when applied individually under similar circumstances." *Nelson v. City of Davis*, No. 10-16256, 2012 U.S. App. LEXIS 14140 (9th Cir. July 11, 2012).

Warrantless Search of Vehicle

In 2009, narcotics detectives (including Detective Hankel) and officers were conducting surveillance of a suspected narcotics stash house in Pacoima, California. They saw a man carry a large white box out of the house, place it into a truck, and drive away. They learned that the man pulled over nearby, took the box out of his car, and transferred it into a white GMC Envoy, driven by a second unknown male, later identified as Cervantes. Officers now began following the movements of the GMC Envoy. Cervantes did not take a direct route to his location, and Hankel concluded that this was a "counter-surveillance" driving technique that indicated Cervantes was engaging in narcotics trafficking. Cervantes drove to a residence on Polk Street, parked, got out empty-handed, and did not come back to the GMC Envoy for about five hours. When he did, Hankel asked a marked police unit to develop a lawful reason to conduct a traffic stop. Officers stopped Cervantes after he failed to come to a complete stop behind the limit line at an intersection. When asked, he was unable to find his license, registration, and proof of insurance.

The traffic stop officers performed a pat-down search for weapons. Cervantes told them that he had been arrested previously for a DUI and his license had been taken away. After finding no record of a driver's license under the name that Cervantes provided, the officers concluded that Cervantes was driving without a license and decided to impound and search his vehicle. During the inventory search of the vehicle, Officer Colley located the white cardboard box in the rear passenger scat. It contained approximately two kilograms of cocaine. Once he was positively identified at the police station, Department of Motor Vehicles records confirmed that Cervantes did, in fact, have a valid driver' license.

Cervantes moved to suppress the cocaine found in his vehicle, claiming that the officers searched his vehicle in violation of the Fourth Amendment. The district court denied his motion to suppress, finding that the officers had lawfully impounded the vehicle, and that the impoundment and search were justified under the community caretaking exception to the Fourth Amendment's warrant requirement. In the alternative, the district court found that the officers had probable cause to search Cervantes's vehicle and, consequently, held that the search was valid under the automobile exception to the Fourth Amendment's warrant requirement.

On appeal, the U.S. Court of Appeals for the Ninth Circuit reversed. The government contended that the officers had probable cause to search Cervantes's vehicle based on Hankel's (1) conclusory statement that the box in Cervantes's possession came from a "suspected narcotics stash house," and (2) observation that Cervantes "did not take a direct route to his location." These assertions failed to establish probable cause. Hankel failed to provide any underlying facts as to why he, or any other officers, suspected the house was a narcotics stash location, and much of the activity described by Hankel was consistent with "perfectly innocent behavior."

The impoundment and subsequent inventory search of the defendant's vehicle were not justified by the community caretaking exception to the Fourth Amendment's warrant requirement, because neither of the officers on the scene provided any testimony that Cervantes's vehicle was parked illegally, posed a safety hazard, or was vulnerable to vandalism or theft. Moreover, it was not clear that those officers complied with the California Vehicle Code when they impounded Cervantes's vehicle, as they impounded and searched the vehicle first, and then arrested Cervantes. An inventory search could not be used as "a ruse for a general rummaging in order to discover incriminating evidence." *U.S. v. Cervantes*, No. 09-50521, 2012 U.S. App. LEXIS 10456 (9th Cir. May 16, 2012). ML

Federal *Cont'd from page 18*

> (v) the underwriter will review the official statement for the issuer's securities in accordance with, and as part of, its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction.

The underwriter also must not recommend that the issuer not retain a municipal advisor. In addition, the MSRB's interpretation requires underwriters to make certain disclosures to municipal issuers regarding transactional risks.

Continued on page 38

Federal *Cont'd from page 37*

H.R. 2827, which is pending currently before the House Financial Services Committee, was introduced by Robert Dold (R-IL) and is titled "To amend the Securities Exchange Act of 1934 to clarify provisions relating to regulation of municipal advisors, and for other purposes." In the form approved by the Subcommittee on Capital Markets and Government Sponsored Enterprises and sent to the full Committee, H.R. 2827 would eliminate the fiduciary duty for all municipal advisors. The bill would exempt dealers and all other financial institutions from regulation as municipal advisors, even when serving as financial advisors (as opposed to serving as underwriters). Further, the bill would permit municipal advisors to deal with their municipal-entity clients as principals (i.e., in arms'-length, instead of agency, capacities) to accommodate cross-selling of products and services, as opposed to a focus solely upon issuers' actual needs, and would make other changes to the significant disadvantage of state and local governments. The bill also would exempt appointed officials from the definition of "municipal advisor," although, as noted, the SEC is expected to take similar action in its final definition.

Rep. Dold and his staff, as well as certain key interest groups, have been commendably willing to listen to comments, however, and have signaled that H.R. 2827 may be amended significantly to eliminate some of the more objectionable provisions. Unfortunately, that has not occurred as of this writing early in August 2012, and one cannot predict the legislative process. There are powerful interests that remain in favor of H.R. 2827 in its present form. Moreover, special interests are seeking exemptions for the preparation of financial feasibility studies, which are among the most important financial advice upon which issuers rely in issuing bonds for highly risky start-up or rapidly-expanding projects (e.g., the Harrisburg, PA, incinerator, the Jefferson County, AL, sewer system, and the WPPSS nuclear plants).

This is legislation that bears watching closely. If it is not enacted in 2012, it almost certainly will reappear in some form in the next Congress. State and local governments have much at stake and much to lose. When state and local governments make ill-advised decisions to issue bonds for unsound projects, defaults can and do occur (e.g., numerous private prisons, nursing homes, toll roads and sports arenas, and a telecom system, a toll bridge, a monorail, a manufacturing plant, a technology facility, and a steam utility). In those instances, at times, taxpayers and ratepayers can, and do, lose many millions of dollars in losses and litigation, and investors can be, and are, harmed.

(Robert Doty is the author of The Bloomberg Visual Guide to Municipal Bonds (John Wiley & Sons and Bloomberg Press, 2012), which discusses the diversity and complexity of municipal securities and the municipal market. He is an officer of a registered municipal advisor to municipal securities issuers. He also is President and proprietor of AGFS, his private consulting firm in Sacramento.) ML

Second Look *Cont'd from page 30*

untrustworthy. *Compare Beech Aircraft Corp. v. Rainey*, 488 U.S. 153, 169 (1988) with *Moss v. Ole S. Real Estate, Inc.*, 933 F.2d 1300 (5th Cir. 1991). Interestingly, the limitation under Rule 803(8)(B), that the circumstances do not indicated lack of trustworthiness, can be ignored if the employee's report is within the scope of his or her official duties. If that is the case, even if the report contains hearsay or speculation, it can come in as a party's prior statement under Fed. R. Evid. 801(d)(2)(D), at least against the municipality. *See Mister v. Ne. Ill. Commuter R.R. Corp.*, 571 F.3d 696, 698 (7th Cir. 2009).

Unofficial or draft written or verbal statements of municipal employees on matters related to their duties, and reports by outside contractors. Courts will exercise discretion about admitting draft reports, or in attributing outside contractors' reports to the commissioning municipality, under Rule 801(d)(2)(D) as a prior statement of a party. However, at least where a series of drafts were closely monitored by city staff as they evolved, and the city closely supervised a contractor's work, there is a substantial likelihood that the drafts and contractor reports will be admissible against the municipality. *See Beech Aircraft Corp. v. Rainey*, 488 U.S. 153, 166 (1988). In theory, the same rationale should permit such reports to be used by the city in support of its own position, but I think the courts would make that more difficult.

Records of Regularly-Conducted Activity. To the extent that information is regularly recorded pursuant to a municipality's normal or usual business, courts likely will admit that information for the truth of the matters stated. *See* Fed. R. Evid. 803(6). This is so even though sometimes, the information may be hearsay because one of the predicates for admissibility under Rule 803(6) is lacking. The most common gap under Rule 803(6) is a failure to prove that the source of the information in the record is "someone with knowledge." Fed. R. Evid. 803(6)((A). Often, the municipality fails to object under Rule 803(6) when there is an offer of information provided by the public, which a municipal employee records ministerially, but without verifying it. For example, a water customer's statement of his residential address, when opening an account, is unlikely to be verified by the municipal water utility (and even if verified, the verification would rely on hearsay documentation).

All too often, the municipality wants information to come in, and so contributes to the general acceptance of its records as proving the truth of matters stated, so that it becomes difficult for it to take the contrary position. Courts find it convenient to rely on government records, and naturally, will be hostile to technical objections under Rule 803(6). However, where the source of the information in the municipal record is the opposing party, or the municipality has no indication that the information is accurate, an objection is appropriate, particularly if the municipality can cast doubt on the reliability of the record. While the proponent may assert that an objection based on reliability should only go to weight, the often-overlooked final predicate for admissibility of a record of regularly-conducted activity under Rule 803(6) is "(E) neither the source of information nor the method or circumstances of preparation indicate a lack of trustworthiness." ML