The Board believes that rules G-37 and G-20, along with rule G-17, on fair dealing,⁷ set appropriate standards for dealer conduct in the municipal securities industry. However, the Board is concerned about dealers' increasing use of consultants to obtain or retain municipal securities business. While the Board believes that in many instances the use of consultants is appropriate, it also believes that, in a number of instances, the use of consultants may be in response to limitations placed on dealer activities by rule G-37 and rule G–20.8 While both of these rules prohibit dealers from doing indirectly what they are precluded from doing directly, indirect activities often are difficult to prove. The Board recognizes that vigorous enforcement of its rules, as well as the antifraud provisions of the federal securities laws, will be effective in uncovering improper conduct, as well as deterring further violations, in connection with municipal securities business. Notwithstanding such efforts, or the current rule G–37 requirement that dealers disclose certain information about consultant arrangements, the Board believes that additional information about such arrangements should be made available to issuers and the public. Currently, the limited amount of information regarding consulting arrangements and the role of consultants in helping dealers obtain or retain municipal securities business makes it difficult to determine the extent to which payments to consultants influence the issuer's selection process in connection with municipal securities business, as well as the extent to which such payments increase the cost of

⁸For example, the Commission has charged that kickbacks and conflicts of interest have occurred in connection with municipal securities offerings. In one instance, the Commission alleged that dealer personnel paid a large kickback to the issuer's financial advisor and inflated the underwriters discount to fund the kickback. See SEC Litigation Release No. 14421 (February 23, 1995) regarding SEC v. Nicholas A. Rudi, Joseph C. Salema, Public Capital Advisors, Inc. (formerly known as Consolidated Financial Management, Inc.), George L. Tuttle, Jr. and Alexander S. Williams. In another instance, the SEC alleged that dealer personnel provided loans and direct payments to an employee of an issuer that had an important role in selecting the underwriter. See SEC Litigation Release No. 14397 (January 23, 1995) regarding SEC v. Terry D. Busbee and Preston C. Bynum.

bringing municipal securities issues to market. The Board believes that disclosure of consulting arrangements (even those that would not result in any rule violations) is necessary. Furthermore, the Board believes that disclosure requirements regarding consultants should be embodied in a separate rule in order to highlight the importance of this information and to facilitate its disclosure to, and accessibility by, the municipal securities market and the public. Accordingly, the Board is proposing new rule G-38, on consultants. At this time, the board is not proposing any substantive restrictions on arrangements between dealers and consultants. If, at a later date, the Board learns of specific dealer practices regarding the use of consultants that it believes should be addressed, then the Board may proceed with additional rulemaking in this area.

Background

In April 1995, the Board published for comment draft rule G-38 ("April 1995 Draft Rule'').⁹ The April 1995 Draft Rule would have required dealers to have written agreements with consultants and to disclose such arrangements to issuers and to the public through disclosure to the Board. It defined the term "consultant" very broadly, and included, among others, persons that acted as "finders" for municipal securities business or that lobbied state and local government officials. The term also included persons who engaged in legal, accounting or financial advisory services if such persons were engaged, even in part, because they could assist a dealer in efforts to obtain or retain municipal securities business with an issuer, and included persons engaged by a dealer at the request or direction of the issuer (e.g., underwriter's counsel).

While most of the commenters responding to the April 1995 Draft Rule supported the Board's goal of making additional information on consultants available to the market, many expressed concern that the definition of consultant was too broad and included a number of categories of persons who did not perform "traditional" consulting roles or services.¹⁰ The Board carefully considered these and other concerns and suggestions expressed by the commenters, and adopted the proposed rule change. Proposed rule G-38 differs in certain respects from the April 1995 Draft Rule, particularly with regard to the definition of consultant. By making

such changes, the Board believes that the proposed rule effectively addresses concerns raised by the commenters without sacrificing the Board's goal of making information about consultants available to issuers and the public.

Summary of Proposed Rule G–38

Definition of Consultant

Proposed rule G-38 defines consultant as any person used by a dealer to obtain or retain municipal securities business through direct or indirect communication by such person with an issuer on the dealer's behalf where the communication is undertaken by such person in exchange for, or with the understanding of receiving, payment from the dealer or any other person.¹¹ The definition specifically excludes "municipal finance professionals," as that term is defined in rule G-37(g)(iv), because such individuals are covered by the requirements of rule G-37. The definition also excludes any person whose sold basis of compensation from the dealer is the actual provision of legal advice, accounting or engineering assistance in connection with the municipal securities business that the dealer is seeking to obtain or retain. The exclusion would apply, for example, to a lawyer retained to conduct a legal analysis on a particular transaction contemplated by the dealer, or to review local regulations; an accountant retained to conduct a tax analysis or to scrutinize financial reports; or an engineer retained to perform a technical review or feasibility study. The exemption is intended to ensure that professionals who are engaged by the dealer solely to perform substantive work in connection with municipal securities business are not brought within the definition of consultant as long as their compensation is in consideration of only those professional services actually

or tickets to theatrical, sporting, and other entertainments, as well as the sponsoring of legitimate business functions that are recognized by the IRS as deductible business expenses, and gifts of reminder advertising. However, the rule also provides that such gifts can not be so frequent or so expensive as to raise a suggestion of unethical conduct.

⁷Rule G–17 provides that, in the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

⁹ MSRB Reports, Vol. 15, No. 1 (April 1995) at 3–10.

¹⁰ A summary of these comments is discussed *infra* Section II.C.

¹¹ "Person" is defined in Section 3(a)(9) of the Securities Exchange Act of 1934 as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."

[&]quot;Municipal securities business" has the same meaning as in rule G-37(g)(vii), i.e., (A) the purchase of a primary offering (as defined in rule A-13(d)) of municipal securities from the issuer on other than a competitive bid basis (i.e., negotiated underwriting); (B) the offer or sale of a primary offering of municipal securities on behalf of any issuer (i.e., private placement); (C) the provision of financial advisory or consultant services to or on behalf of an issuer with respect to a primary offering of municipal securities on other than a competitive basis; or (D) the provision of remarketing agent services to or on behalf of an issuer with respect to a primary offering of municipal securities on other than a competitive bid basis.

[&]quot;Payment" has the same meaning as in rule G– 37(g)(viii), *i.e.*, any gift, subscription, loan, advance, or deposit of money or anything of value.