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The SEC's Heightened Scrutiny of Broker-Dealer Municipal Securities Underwriting and Public Entity Sales Practices

Recent Activity Reflects Increased Coordination of SEC Examination and Enforcement Staff

Following its much publicized 2010 enforcement division reorganization, the results of the SEC's increased efforts to police public sector securities transactions are now emerging. These efforts have been spearheaded by the enforcement division's Municipal Securities and Public Pensions unit, or MSPP, which has been working in close coordination with the SEC's Office of Compliance Inspections and Examinations (OCIE) staff. The headline enforcement actions in this area have involved municipal securities pricing and valuation fraud, public pension accounting and disclosure fraud, and "pay-to-play" activities and other forms of public corruption. However, a significant pattern of examination and enforcement activity is emerging concerning more fundamental broker-dealer sales practices and underwriting activities. These cases reflect an emphasis of the SEC on municipal securities underwriting practices and broker-dealer suitability obligations owed to public entity investors.

The SEC is conducting a broad review of municipal securities offerings with a focus, for the first time, on the sufficiency of an underwriter's due diligence procedures to fully discharge its obligations under Rule 15c2-12 of the Securities Exchange Act of 1934. FINRA also included municipal securities in its January 31, 2012, letter on regulatory and examination priorities.

In light of this heightened scrutiny, we recommend that municipal securities underwriters closely review the conduct and documentation of their ongoing due diligence activities. Compliance personnel should also confirm that their firms have adequate written supervisory procedures regarding due diligence activities; that sufficient records are retained and organized to reflect such activities; that personnel involved in performing due diligence have appropriate experience, training and oversight; and that supervisors and other responsible employees are aware of the increased scrutiny in this area.

With respect to sales practices, the SEC has delivered a clear message that it views many public entity investors as being less sophisticated than traditional institutional investors, and even has referred to them as "quasi-institutional" customers. The SEC will seek to hold institutional broker-dealers to a heightened duty of care under FINRA's suitability rules when they transact in securities in a public entity customer's account. Although the fundamental regulatory principles remain in place, the SEC is taking a much closer look at whether brokers: (1) have engaged in a sufficient evaluation of the risk of recommended securities; and (2) whether they properly evaluated a customer's ability to independently evaluate the risk of recommended securities in accordance with FINRA Rule 2111. The SEC also has indicated that broker-dealers may be required to establish heightened or special supervisory procedures with respect to the sale of securities to less sophisticated public entity customers, which may be at odds with the customer-directed transaction model employed by many institutional broker-dealers.

We encourage our broker-dealer clients to revisit their suitability procedures that involve public entity customer sales practices. Among other things, compliance personnel should consider the extent to which brokers conduct and document their evaluation of customer sophistication and the manner in which supervisors ensure that brokers have sufficient product knowledge and understand the performance characteristics and risks of recommended securities.

We expect the overall trend of increased OCIE enforcement referral activity to continue and that these broker-dealer activities will continue to be focal points of the SEC's examination and enforcement programs for some time. For that reason, we strongly recommend that broker-dealers prepare diligently for any upcoming regulatory examinations that may touch upon these areas.

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