The Role of Financing Team Members: Impact of the New Municipal Advisor Regulations

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Historical Overview

- Prior to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, Municipal Advisors were largely unregulated
  - Virtually anybody could hang their shingle as financial advisor without oversight
- Some bad actors and bad practices inspired Congress to act
  - "Pay to Play" practices, where business was tied to political contributions
  - Advice rendered by untrained or unqualified financial advisors
  - Advisors placed their own interests ahead of their duty to their clients' interests

Goals of Dodd-Frank for Public Finance Industry

- Expanded the mission of the Municipal Securities Rulemaking Board (MSRB) to include protection of municipal entities in addition to its historic role of protecting investors
- Required regulation of a new defined category of professionals, the "Municipal Advisor" (or "MA")
  - Defined categories of persons deemed Municipal Advisors
  - Established permanent registration regime
- Assigned federal fiduciary duty owed by MA's to clients that are municipal entities
- Fiduciary duty includes: a Duty of Care and a Duty of Loyalty

Who is a "Municipal Advisor?"

- **SEC Final Registration Rule created exemptions based on activities of advisor, rather than type of market participant.**
  - Public officials and employees
  - Investment Advisers giving investment advice on proceeds of municipal securities
  - Attorneys giving legal advice
  - Engineers providing engineering advice (i.e. feasibility reports)
  - Accountants providing accounting services (i.e. audits)
  - Swap dealers advising regarding swaps where issuer has an independent advisor

What does "Advice" really mean?

- A person is providing "advice" to a municipal entity or an "obligated person" based on "all of the relevant facts and circumstances," including whether the advice:
  - Involves a "recommendation" to a municipal entity.
  - Is particularized to the specific needs of a municipal entity.
  - Relates to municipal financial products or the issuance of municipal securities.
  - Advice, however, does not include giving out certain general information.

Exemptions for Broker Dealers

- If a firm is contractually engaged to serve as underwriter on a specific transaction, certain advice provided under that engagement does not trigger MA treatment

- Dealers are exempt from MA treatment if the issuer has engaged an "independent registered municipal advisor" and if that issuer relies on the MA's advice for final adoption of the financing plan. This requires a *written* representation from the issuer – i.e., the infamous "IRMA" letter.

- Dealers are exempt from MA treatment when responding to issuers' requests for proposals (RFPs)

Proposed MSRB Rule G-42

- Proposed Rule G-42 establishes core standards of conduct and duties of MAs, other than when engaging in solicitation activities. Highlights include:
  - Expands on duty of care
  - Requires MAs to disclose conflicts of interest and document their MA relationship
  - Prohibits recommending transactions or products unless MA has reasonable basis for believing its suitability for the client.
  - Review recommendations of third parties, when asked.
  - Prohibits MA from engaging in any transaction as a principal
  - Requirement to "know" one's client

Duty of Care

- Due care in performing municipal advisory activities
- Knowledge and expertise
- Inquiry and Investigation
  - Make reasonable inquiry of relevant facts that form basis of advice
  - Conduct reasonable investigation to determine that it is not basing any recommendation on materially inaccurate or incomplete information
  - Thoroughly review the official statement unless scope of engagement is limited knowledge and expertise necessary to provide informed advice

Source: Presentation : "MSRB Draft Rule G-42: Duties of Non-Solicitor Municipal Advisors", Municipal Securities Rulemaking Board, dated, February 6, 2014

Duty of Loyalty

- Municipal advisors owe a duty of loyalty to their municipal entity clients when performing municipal advisory activities
- Municipal advisors must, at or prior to the inception of a municipal advisory relationship, provide the client with written disclosure of all material conflicts of interest
- Disclosures must be sufficiently detailed and must explain how the advisor addresses or intends to manage or mitigate each conflict

Source: Presentation : "MSRB Draft Rule G-42: Duties of Non-Solicitor Municipal Advisors", Municipal Securities Rulemaking Board, dated, February 6, 2014

Potential Conflicts of Interest - Compensation

- Start with premise that no relationships involving compensation are without potential conflicts of interest
- Potential conflicts include:
  - Over servicing, where the MA is paid hourly
  - Under servicing, where the MA is paid a fixed fee or retainer
  - "Self-serving" advice where compensation is contingent or based on par amount
- Excessive compensation
  - Of course, under compensation creates its own incentives

Potential Conflicts of Interest (cont.)

- Dual roles or selling of multiple services or products of MA
  - Investment management, swap advisory, GO bond election services, underwriting
- Payments to or from third parties
- Non-client alliances – e.g., with underwriters or bond counsels
- Advance Refundings: Municipal Advisor gets paid now, although issuer might be better served by waiting
- Use of complex products or structures: requires more advisory services

Recommendations Made by the Municipal Advisor

- A municipal advisor must have a reasonable basis to believe its recommendation is suitable for the clients
- A municipal advisor may only recommend a municipal securities transaction or municipal financial product that is in the client's best interest
- The municipal advisor must discuss with its client:
  - Its evaluation of the material risks, potential benefits, structure and other characteristics
  - The basis for its suitability determination
  - Whether it considered other reasonably feasible alternatives

Source: Presentation : "MSRB Draft Rule G-42: Duties of Non-Solicitor Municipal Advisors", Municipal Securities Rulemaking Board, dated, February 6, 2014

MSRB Rule G-17

- Requirement of "Fair Dealing" by broker-dealers and MAs;
  - precludes deceptive, dishonest or unfair practice
  - owed by dealers to investors and to other entities, including municipal issuers

- Requires underwriters to make disclosures regarding: their role, basis of compensation, conflicts of interest and the material aspects of a financing structure, particularly when complex, such as variable rate and derivative structures – infamous G-17 letters

- Other issues: excessive compensation, fair bond pricing

Source: MSRB Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities – August 2, 2012

Take-Aways

- Final MA Registration Rule has impacted the roles of all financing team members
- New protections as well as increased paperwork to document relationships and disclose potential conflicts
- Have your MA review IRMA and G-17 letters
- Remember, regulation is not a guarantee of good behavior
  - MA reputational risk
  - Emphasize competency and experience in selection process
  - Inquire about MA firm internal policies, practices, education and training
  - Develop debt management policies