Role of a Municipal Advisor:
The SEC Municipal Advisor Rule

Kern County Superintendent of Schools
Understanding and Managing Debt
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Overview of Presentation

- How Do Federal Regulatory Agencies Work
- Dodd-Frank Act: Regulation of Municipal Advisors
- Dodd-Frank Act: Transparency and Protection for Issuers
- Who Works for Your Benefit?
- What is Fiduciary Duty?
- The Municipal Advisor Rule in Practice

Federal Regulatory Overview: How SEC and MSRB Work

- SEC is an independent federal regulatory agency. It is not part of the executive branch but the president appoints the Commissioners. No more than three (of five) can be from one political party. Commissioners can only be removed for cause not "at will" of President.
- SEC regulations have the force of federal law.
- Congress can direct the SEC to pass certain regulations.
- Dodd-Frank Act contains many such examples of Congress directing the SEC to pass regulations including the "municipal advisor rule."
- SEC also oversees "self-regulatory" organizations such as the Municipal Securities Rulemaking Board (MSRB).

Federal Regulatory Overview: How SEC and MSRB Work

- SEC generally writes "big picture" policy rules and detailed rules are written by the MSRB.
- Formerly the MSRB Board was composed of 10 underwriter or bank representatives and 5 public members.
- After Dodd-Frank, the MSRB has 11 public members and 10 regulated representatives (underwriters, banks and municipal advisors).
- MSRB rules are subject to approval by the SEC but the standard is low: "consistent with the Securities Exchange Act of 1934."
- Most of the rules governing municipal advisors will be written by the MSRB.

Federal Regulatory Awareness

- In performing debt management duties issuers have many things to be concerned about and the SEC and MSRB are not at the top of those lists.
- Helpful to be aware (but not afraid) of SEC and MSRB especially since they have a new mandate to provide you with information to help you make good financial decisions.
- SEC will still enforce disclosure fraud against issuers but will also act to recoup funds for issuers as consumers of financial products.

Dodd-Frank Act—Reguires Registration of Persons that Provide "Municipal Advice"

- Temporary regulation has been in effect since October 1, 2010.
- Final Rule was effective on July 1, 2014.
- Defining Municipal Advisor: Persons Who Give Advice about Municipal Financial Products (GICs, Swaps, Investments) and the Issuance of Bonds.
- A Municipal Advisor includes not only traditional "financial advisors" but anyone that provides "advice" to a municipal entity about bonds or specified financial products.
- Also affects your underwriter, your bond counsel and other parties if they act outside of their prescribed role.

Dodd-Frank Act—Does The Municipal Advisor Rule Regulate Issuers?

- The Municipal Advisor Rule does not regulate issuers in any way.
- Generally it is a "consumer protection" rule for issuers imposing higher standards of conduct on persons who provide you financial services.
- Municipal issuers have zero compliance obligations under the municipal advisor rule.
- Only applies to you as an issuer official if you are running a side business providing municipal advice outside of your official duties.

Dodd-Frank Act—Why Regulate Municipal Advisors?

- Municipal Issuers/Taxpayers harmed by poor advice given by market participants.
- Certain market participants were completely unregulated and there was no prohibition on pay-to-play practices or excessive gift-giving by these persons. Harder to police corrupt practices without these rules in effect.
- Congress and the SEC concerned about specific losses by municipal issuers but also about market integrity.
- Poor perception of the municipal market costs all issuers money in the form of higher borrowing costs (Meredith Whitney). Goes beyond bribes and obvious corruption.
- Actions of financial services providers often made it hard for issuers to tell who was their advisor and who was "on the other side of the table."

Municipal Advisor Rule and Transparency: Who Is Acting For Your Benefit?

- MA regulation and other MSRB Rules seek to provide transparency to issuers as consumers of financial advice.
- Rules aim to provide transparency about roles and duties of bond transaction participants.
- Municipal advisors (and lawyers) MUST act in your best interests regardless of their own interests.
- Underwriters and banks are NOT required to act in your best interests but must deal "fairly" with you and with your other advisors.
- Because municipal advisors MUST act in your best interests and have a fiduciary duty to you, the Government Finance Officers Association (GFOA) and other issuer groups recommend hiring a municipal advisor through a competitive process to assist you.

Municipal Advisor Rule and Issuer Protection: "Fiduciary Duty" of Municipal Advisors

- Overall rule is designed to provide heightened protection for municipal issuers by imposing a "fiduciary duty" on advice received with respect to bonds and specified municipal financial products (GICs, Swaps, Investment of Bond Proceeds).

What Does Fiduciary Duty Mean?

- Most simply: A Municipal Advisor has to put your interests ahead of their own.
- EXAMPLE ONE: Issuer is considering a refunding and municipal advisor will only get paid if the transaction is completed. Interest rates rise making the transaction less beneficial to issuer.
- EXAMPLE TWO: Issuer is considering new money bond deal for school construction. Municipal advisor gets paid as a percentage of bond size. Some of the construction projects have begun but the timing for others is more speculative because of planning and community concerns.
- Most commonly fiduciary duty is said to include a "duty of care" and a "duty of loyalty."

Fiduciary Duty: DUTY OF LOYALTY

- A municipal advisor must deal honestly and with the utmost good faith with a municipal entity client and act in the client's best interests without regard to the financial or other interests of the municipal advisor.
- A municipal advisor to a municipal entity client must either eliminate or provide full and fair disclosure to the client about each of its material conflicts of interest.
- A municipal advisor must not engage in municipal advisory activities with a municipal entity client if it cannot manage or mitigate its conflicts in a manner that will permit it to act in the municipal entity client's best interests.
- We will discuss conflicts in more detail in the next session.

Fiduciary Duty: DUTY OF CARE

- A municipal advisor must possess the degree of knowledge and expertise needed to provide the municipal entity or obligated person client with informed advice.
- A municipal advisor also must make a reasonable inquiry as to the facts that are relevant to a client's determination as to whether to proceed with a course of action or that form the basis for any advice provided to the client.
- Municipal advisors will have testing and training requirements.

Municipal Advisor Rule in Practice—What Will Be Different For Issuers?

- Most importantly, your advisors will have a higher duty to you. They need to "have your back."
- Financial service providers will have to provide more details about their role and their conflicts of interest.
- Designed to put issuers (not the SEC) in control of their processes and decisions by deciding which exemptions, if any, to put into use.
- As a practical matter, issuers will see changes in the way municipal advisors, underwriters and other parties interact with you.

Municipal Advisor Rule in Practice—What Will Be Different For Issuers?

- These regulated parties may ask you to sign various certificates or provide representations in order for you to help them with their compliance obligations.
- As a threshold matter, remember that an issuer is not required to provide any such certificates or representations.
- If they make you uncomfortable or are unclear: don't sign. Deals can still be done.
- You will see more paper but you can easily significantly limit the paper by taking control of the process.
- Consult with Schools Legal Service or other counsel before signing documents which may waive fiduciary protection.

Municipal Advisor Rule in Practice—Dealing With Main Exemptions Without Creating Paperwork

- Three main exemptions that will arise in the course of debt management:
  - RFP exemption
  - IRMA exemption
  - Underwriter exemption

- There are also exemptions for attorneys and banks and other parties that will arise less frequently.

Municipal Advisor Rule in Practice—Dealing With Main Exemptions Without Creating Paperwork

- Exemption 1: RFP. If an issuer has an RFP out for financial services (e.g. underwriters) then firms can respond to the RFP and it is not considered municipal advice. *An issuer should not have to provide any additional certificates or representations to regulated parties with respect to its RFPs.*
- Your regular RFP format – with at most minor tweaks -- should be sufficient evidence for regulated parties particularly if it is posted publicly or clearly sent to more than three firms.

Municipal Advisor Rule in Practice—Dealing With Main Exemptions Without Creating Paperwork

- Exception 2: IRMA. In recognition of the GFOA best practice recommending the hiring of a municipal advisor, when an issuer has hired an independent registered municipal advisor (IRMA) to advise them either generally or on specific bond deals other parties can provide advice to the issuer. As an accommodation to regulated parties, an issuer can make representations on their website (or provide a form certificate that they have drafted) that they will rely on their municipal advisors and include the names of the individuals and firms it has hired as municipal advisors. *The Issuer is not required to determine whether the IRMA is independent of the persons who seek to rely on the exemption and should not have to provide any certificates or representations to regulated parties other than the public notification noted above.*

Municipal Advisor Rule in Practice—Dealing With Main Exemptions Without Creating Paperwork

Exemption 3. Underwriter Exemption. Issuer has hired an Underwriter. When the Issuer has gone through the RFP process and hired an underwriter for a specific transaction, the underwriter may provide limited advice to the Issuer related to that specific transaction if the Issuer does not have a municipal advisor. *The Issuer is not required to but may provide "preliminary engagement letters" to underwriters.* However, the Underwriter may use other indicia of engagement (including e-mails, memorialization of phone conversations, IP lists, timetables and draft financing documents) to document that it is "serving as underwriter" if it has actually been engaged by the Issuer to serve in that role without the Issuer having to provide separate documentation.

Questions?

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Understanding Conflicts of Interest

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Overview of Presentation

- Types of Conflict of Interest
- Form 700 Concerns
- Required Documents Provided by Underwriters, Municipal Advisors and Lawyers
- Types Questions to Ask About Conflicts

Conflicts of Interest: Who Cares About Conflicts and Disclosure of Conflicts

- Short answer: Everybody. Especially if something goes wrong.

Conflicts of Interest Occur in Many Types of Scenarios

- All of your interactions with third parties and their interactions with you potentially involve conflicts of interest.
- Conflicts can arise all the time but this presentation will focus mainly on issues that arise during debt process.
- Principles discussed today apply in other scenarios as well.
- The state has conflict of interest rules governing your interactions with "vendors" (Form 700) and both the state and the federal government have rules governing financial service providers.

Form 700 Disclosure is an Example of Conflict Disclosure that You Provide

- California FPPC is cracking down on issuer officials for Form 700 violations.
- Underwriters and municipal advisors (and other parties) are generally allowed to give you up to $440 in gifts in a calendar year but you must report gifts over $50.
- Gifts from a single source aggregating to $50 or more must be disclosed, and gifts aggregating to $440 or more during any 12-month period may subject an official to disqualification with respect to that source (can't hire for services).
- These rules are more strict than MSRB rules because they include business lunches and sporting events -- consult your local rules and Schools Legal Service.

Form 700 Disclosure: How Do Problems Arise?

- Usually not intentional violations by public officials.
- If FPPC requests information from a vendor, vendor will generally only report average cost per attendee. For meals or hospitality suites vendors will not monitor actual amounts consumed by issuer officials.
- However, you generally only have to report actual amounts consumed which can lead to a disparity in reports.
- Also be aware of signing up for an event and not attending because vendor will still have you on the guest list.
- If identified by a vendor as receiving gifts in excess of reporting requirement that you did not receive – do not panic – FPPC will allow you to challenge the report.
- But, helpful to have documentation to avoid political fallout.

Who is Required to Provide Conflict of Interest Disclosure to You

- Municipal Advisors will soon be explicitly required by MSRB Rule to provide conflict of interest disclosures to you
- Underwriters are required by MSRB Rule to provide conflict of interest disclosure to you (G-17 Letters)
- Attorneys

Example: MSRB Rule G-17 Disclosures by Underwriters

- MSRB Notice No. 2012-25 requires underwriters to provide certain disclosures to municipal issuers which include:
  - information regarding the role of the underwriter in the transaction (underwriter is not your advisor)
  - information regarding the compensation structure (contingent fees are inherent conflict of interest)
  - any other conflicts of interest (including third party payments). Underwriter is not required to disclose the amounts of third party payments but has to respond honestly if you ask for such amounts. Hint: Ask for amounts of these payments!
  - the material financial aspects and any associated risk in the proposed financing structure.

Example: MSRB Rule G-17 Disclosures by Underwriters

- Underwriter is required to attempt to obtain written acknowledgement of the receipt by the issuer of the disclosure.
- An issuer is not obligated to respond. However, you can really help out by "acknowledging receipt." Such acknowledgement of receipt may include a reservation of rights or other self-protective language by the issuer. GFOA has model language to protect your rights.
- Disclosures do contain important information that issuer should read. Most letters are short (2-3 pages).

Conflicts of Interest Disclosure by Municipal Advisors

- Municipal Advisors Will Soon be Required to Provide Similar Conflict Disclosures as those provided by Underwriters.

Conflicts of Interest Disclosure by Lawyers

- Bond counsel will generally ask for a conflict waiver if they have a conflict of interest with respect to a specific matter.
- **Bond counsel will generally <u>not</u> disclose to you if they frequently work for underwriters or banks on the other side of a transaction from you. It is up to you to ask! May be a good idea to make these part of RFP process.**
- Bond counsel often argue that representing these other parties gives them insight into their tactics but they may also be worried about preserving that financial relationship and may not negotiate as vigorously on your behalf.

Types of Conflicts: Recent Texas Example

- RBC Capital Markets and a former employee, R. Craig Rathmann entered into an agreement in 2003 to not compete for financial advisory clients among MUDs in the Houston area when Rathmann left RBC to start his own FA firm.
- In exchange for RBC agreeing not to solicit Rathmann's financial advisory clients, Rathmann agreed to use RBC as lead underwriter for his clients, and secure a fee of 1.25% of the bond sale proceeds.
- During that time RBC was appointed lead underwriter in 112 of 115 negotiated deals involving Rathmann's company.
- PRACTICAL EFFECT: Some conflicts are so obvious that when people engage in them they are very unlikely to actually disclose them (Jefferson County). However, the presence of the rule specifically requiring disclosure makes it easier for issuers to get restitution if rules are violated.

Types of Conflicts: What Questions Should I Be Asking?

- Did you pay anyone to help you get hired? Do you have an agreement with any party to ensure you are hired?
- Who else is paying you?
- In addition to your normal fee, how else are you making money on this deal? How much?
- Do you have relationships with other parties to this transaction that will make it difficult for you to represent us?

Response Example: MSRB Rule G-17 Disclosures by Underwriters – Wading Through Legalese

- In the ordinary course of their various business activities, [Underwriter] and its owners and employees may purchase, sell or hold a broad array of investments and may actively trade securities and other financial instruments for their own account and for the accounts of customers. **Such investment and trading activities may involve or relate to assets, securities and/or instruments of the District** and/or persons and entities with relationships with the District. [Underwriter] also may communicate independent investment recommendations, market advice or trading ideas and/or publish or express independent research views in respect of such assets, securities or instruments and at any time may hold, or recommend to clients that they should acquire, long and/or short positions in such assets, securities and instruments.
- [Underwriter] is not aware of any relationship which would create a conflict of interest or the appearance of a conflict of interest in its role as underwriter to the District. With that said, in the ordinary course of its business**, [Underwriter] maintains relationships with financial advisory firms, investment banks, and law firms,** some of which may have relationships with the District.

Response Example: MSRB Rule G-17 Disclosures by Underwriters – Wading Through Legalese

- Affiliates of the underwriter may serve in separate capacities in connection with the issuance of the Bonds, including serving as letter of credit bank. The affiliated entity will be separately compensated for serving in that capacity. **HOW DOES THIS AFFECT YOUR PRICING OF THE BONDS? HOW MUCH DO YOU MAKE FROM THIS?**
- [The underwriter] expects to receive a payment, value, or credit from its affiliated swap dealer affiliate if the Issuer decides to enter into an interest rate swap on the Bonds. **HOW DOES THIS AFFECT YOUR PRICING OF THE BONDS? HOW MUCH DO YOU MAKE FROM THIS?**
- Underwriter [may/intends to] place Bonds in the underwriter's or an affiliate's tender option bond program to be held for the account of the underwriter or the affiliate. **HOW DOES THIS AFFECT YOUR PRICING OF THE BONDS? HOW MUCH DO YOU MAKE FROM THIS?**

Types of Conflicts: How Do I Determine What Matters

- Conflict of interest disclosures are supposed to be are starting point for discussion – ask questions!
- Use your common sense – money and power are generally the most corrupting influences.
- Beware of supposed freebies. If you are being offered a "freebie" there can be a hidden conflict (undisclosed payment) or an oversized fee built into the overall package.
- You are not required to know everything: Consult with Schools Legal Service about legal conflicts. Consult with the Debt Advisory Service Team and your municipal advisor (FA), as appropriate, about financial conflicts of interest.

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