The Municipal Advisor Rule: Why This Matters to State and Local Governments

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Overview of the
Final Municipal Advisor Registration Rules
Introduction and Background

Response to Issues in 2008 Financial Crisis

- Concerns arose in 2008 financial crisis about unregulated or unqualified financial advisors to municipalities, advisors with conflicts of interest, issues involving pay-to-play, and advice on complex municipal derivatives in which municipalities suffered significant losses.

Statute and Purpose

- In response to these concerns, in the Dodd-Frank Act, Congress added a broad new requirement that “municipal advisors” register with the Securities and Exchange Commission, effective October 1, 2010.

- This municipal advisor provision aims to enhance protections to municipal entities and it imposes a new fiduciary duty on municipal advisors to act in the best interests of their municipal entity clients.
SEC Final Rules and Interpretive Guidance

SEC Final Rules


- These final municipal advisor rules go into effect on July 1, 2014.

SEC Interpretive Guidance

Municipal Advisor Rules Regulate Advisors to Municipal Entities—They Do Not Regulate Municipal Entities

Regulated Persons

- The municipal advisor rules regulate certain persons who provide advice to municipal entities and obligated persons on certain subjects.
- The municipal advisor rules do not regulate municipal entities themselves.

Broad Exemption for Public Officials

- The final municipal advisor rules have a broad exemption for public officials which covers any person (elected or appointed) serving as a member of a governing body, advisory board, committee, or similar official capacity of a municipal entity or obligated person to the full extent that these individuals act within the scope of their official capacities.
- This exemption covers employees of municipal entities and obligated persons that act within the scope of their employment.
- This exemption also covers advice between employees of different municipal entities (e.g., state government agency and a municipality) that act within the scope of their employment.
Statutory and Regulatory Framework

Statutory Municipal Advisor Definition

• The Exchange Act defines the term “municipal advisor” to mean a person that: (1) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products (municipal derivatives, GICs, and “investment strategies”) or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or (2) undertakes certain solicitations of a municipal entity.

SEC Registration Absent an Available Exemption.

○ Absent an available statutory or regulatory exemption, a municipal advisor must register with the SEC and is subject to certain training, qualification, and recordkeeping requirements.
Advice Standard

General guidelines on what constitutes “advice” under the final rules:

- **Facts and Circumstances Standard.** First, advice depends on all of the relevant facts and circumstances.

- **Advice Includes Particular Recommendations.** Second, advice includes certain “recommendations” that are particular to the specific needs, objectives, or circumstances of a municipality.

- **Advice Does Not Include General Information.** Third, advice excludes certain general information that does not involve a recommendation.
General Information is Not Advice

Examples of “general information” that is not considered “advice”:

- Information of a factual nature without subjective assumptions, opinions or views.

- Information that is not particularized to a specific municipal entity or type of municipal entity.

- Information that is widely disseminated for use by the public.

- General information in the nature of educational materials.
Covers Advice on Three Subjects

Under final rules, a person is required to register as a municipal advisor if the person provides advice on one of three subjects:

- (1) issuance of municipal securities, including structure, timing, terms, and other similar matters with respect to such issuance (interpreted broadly time-wise, from early planning to bond redemption);

- (2) investments of proceeds of municipal securities and the recommendation of and brokerage of municipal escrow investments under “investment strategies” definition; and

- (3) municipal derivatives (swaps and security-based swaps).
Process for Determining Bond Proceeds

Written Representation Process for Determining Bond Proceeds
The final municipal advisor rules provide a process for determining whether funds to be invested are municipal bond proceeds:

- A person may rely on a written representation made by a knowledgeable official of a municipal entity or obligated person regarding whether invested funds are municipal bond proceeds. A person must have “reasonable basis” for such reliance.

Nonexclusive Process

- This process of reliance on written representations from municipal entities or obligated persons is not the exclusive means for determining whether invested funds are municipal bond proceeds.

What Municipalities Should Expect

- Municipalities should expect and appreciate that their investment advisors may seek representations from them about whether invested funds are municipal bond proceeds, because this affects whether advisors need to register with the SEC as municipal advisors.
Statutory and Regulatory Exemptions

- The statutory municipal advisor provision includes a series of statutory exemptions to the definition of a municipal advisor. The final municipal advisor rules interpreted the statutory exemptions and also provided certain additional regulatory exemptions. The exemptions focus on certain identified activities of market participants as opposed to the status of market participants.

- **Broad exemption for public officials.** As noted an earlier slide, the final rules include a broad exemption for public officials (both elected and appointed) and public employee who provide advice when acting within the scope of their official capacities.

- The next several slides highlight certain exemptions that are relevant to municipal entities and how they obtain advice from their advisors.
Independent Registered Municipal Advisor Exemption

• An important new exemption permits free flow of information between market participants and municipalities when the municipality is represented by an independent registered municipal advisor.

• To qualify for this exemption, a market participant must receive a written representation from the municipality that the municipality (1) is represented by, and (2) will rely on (meaning seek and consider—but not that it must follow) the advice of its independent registered municipal advisor. A municipality may post a representation to this effect on its official website.

• Requires written disclosure to the municipality that person relying on exemption is not a municipal advisor and not subject to any fiduciary duty.

• The independence test for the registered municipal advisor requires looking a certain entity-level and individual-level associations between the advisor and the market participant for a two-year period.
Underwriter Exclusion

- Exclusion for brokers, dealers, and municipal securities dealers serving as underwriters.

- Covers underwriter’s advice on the issuance of municipal securities (including structure, timing, terms, and other similar matters) from the time of engagement as underwriter on a particular transaction through the end of underwriting period.

- An issuer’s engagement of an underwriter may be on a preliminary basis, subject to conditions such as the approval by issuer’s governing body.

- Does not cover advice on investment of proceeds or municipal derivatives.
Request for Proposal or Qualifications Exemption

- Allows issuers to solicit ideas and advice from market participants in a competitive process.

- Covers written or oral responses to an issuer’s request for proposals (RFP) or request for qualifications (RFQ) that targets 3 or more market participants; provided that the person does not receive separate direct or indirect compensation for advice provided as part of such response.

- Covers written or oral responses to an issuer’s “mini-RFP” that targets 3 or more pre-screened or pre-qualified recipients.

- No formal procurement process is required.
Set forth below is a brief summary of other exemptions to the municipal advisor definition:

- **Registered investment advisers**—covers SEC-registered investment advisers that provide investment advice.
- **Registered commodity trading advisors**—covers CFTC-registered commodity trading advisors that provide advice related to swaps.
- **Banks**—covers certain identified traditional banking activities (e.g., deposits, extensions of credit, loans, and direct purchases of municipal securities for their own account).

- **Attorneys**—covers legal advice and traditional legal services, but not attorneys that hold themselves out as financial advisors or financial experts.
- **Accountants**—covers accountants that provide audit or other attest services, prepare financial statements, or issue letters for underwriters.
- **Engineers**—covers engineering advice.
Certain Additional Information on Municipal Advisors


- **SEC Office of Municipal Securities:** [http://www.sec.gov/municipal](http://www.sec.gov/municipal)

- **Municipal Securities Rulemaking Board:** [http://www.msrb.org/MSRB-For/Municipal-Advisors.aspx](http://www.msrb.org/MSRB-For/Municipal-Advisors.aspx)
The Municipal Advisor Rule: Why this Matters to State and Local Governments

Steve Apfelbacher
Ehlers President
On Behalf of the National Association of Independent Public Finance Advisors

5/23/2014
Dodd-Frank Act

- NAIPFA supports Congressional action to legislate Municipal Advisors
- Why?
  
  History of municipal market participants using their issuer relationship for their self gain at the expense of taxpayers and ratepayers
- Municipal Advisors have fiduciary duty to issuers which establishes clarity in who issuers can trust
- Securities Exchange Commission (SEC) since determined Municipal Advisor Registration Requirements
Municipal Advisor (MA) Definition Observations

- Frequent issuers and infrequent issuers equally impacted
- Rule does not just impact MA’s
- Rule impacts all market participants including issuers
- New behaviors/practices will need to be established
- Parts of the rule will have more significant impact in different states and markets
- Limits “advice” by other professionals unless exemption utilized
  - Bond Counsel
  - Engineers
  - Accountants
  - Local bankers
  - Vendors recommending financing options
Municipal Advisor (MA) Definition Observations

- Advice Underwriter is able to provide more limited also
  - Can not provide advice on certain topics
  - Can not provide advice unless retained
  - Can not provide advice unless an exemption used
    - Request For Proposal (RFP to 3 or more underwriters)
    - Independent Registered Municipal Advisor (IRMA)

- Overtime all underwriters will be selected more for capabilities and not just relationship

- Yet unclear the final impact of various Municipal Securities Rulemaking Board (MSRB) MA Rules
MA Firm Requirements

• How do MA firms comply?
• What client service is MA advice?
• Who at the firm is a MA?
• Security and Exchange Commission (SEC)
  – Registration of MA Firm and MA I’s
  – Maintain specific Books and Records
• Municipal Securities Rulemaking Board (MSRB)
  – Duties of Non-Solicitor MA’s (Contracts, Disclosures)
    • Fiduciary Duty (Duty of Care and Duty of Loyalty)
    • Client Suitability
    • Know Your Client
MA Firm Requirements

• Municipal Securities Rulemaking Board (MSRB)
  – Supervisory and Compliance Obligations (Internal Structure)
  – Professional Qualifications (Test and Continuing Education)
  – Temporary MSRB Fees (Cost of regulation)
  – Pay to Play (Political Contributions)
  – Advertising
  – Gift Limits
  – Permanent MSRB Fees
How SEC/MSRB Rules Affects Issuers

• MA’s engagements will be more formal
  – Written engagement with scope of service defined/compensation
  – Written/ongoing disclosure of conflicts and affiliations

• Unless excluded by written engagement, MA’s likely be obligated to review options and make suitability recommendation

• Independent Registered Municipal Advisor (IRMA)
  Prediction- IRMA will become common practice for those the use a MA but MA needs to be engaged to use IRMA
How SEC/MSRB Rule Affects Issuers

• What exemptions will you use? How will you, the issuer, execute those exemptions?

• What is the role of the MA if an IRMA exemption is used? If MA is not participating in all advice discussions, how do you keep the MA informed to do meet their regulatory obligation?

• Who is your point person who has authority to bind issuer for:
  – MA written agreement and ongoing MA disclosures?
  – Underwriter engagement (Final and preliminary)?
  – IRMA or RFP exemption?
How SEC/MSRB Rule Affects Issuers

• Your bond purchaser cannot invest your bond proceeds so to avoid a problem do you use a Registered Investment Advisor to handle investments?

• Do you involve an MA earlier in your project because of the limitations the rule puts on advice from other professionals?

• Do you use an underwriter MA for a competitive sale knowing that you lose a bidder for that competitive sale?

• If you relied on an underwriter for advice that is now MA advice, who will you use to provide this advice?

• Are you better off using a MA or underwriter to explore your financing options or both?
Summary

• All municipal market participants need to be aware of the MA rule and change our behavior/practice
• There were significant abuses the rule is attempting to correct
• These changes are in the best interests of most of the 50,000 municipal market debt issuers
• This is good for taxpayers and ratepayers
Municipal Advisor Rule:
Why it matters to Small Issuers

Larry M. Sapp, CGFO
Finance Manager
Hilton Head Public Service District
MA Benefits for a Small Issuer

Defines “fiduciary duty” to include duties of loyalty & care
• Municipal Advisor works for YOU!

 Must disclose any conflict of interest
  • Anything that might impair MA’s ability to act in best interest of the issuer

 Can’t act as “underwriter” for bond deal

 Provides market data & guides bond process
  • Brings experience & expertise
  • Assists in the Rating Agency process
Hilton Head No. 1 Public Service District - Background of Issuer:

- Located in South Carolina
- Was created by Act No. 596 of the Acts and Joint Resolution of the General Assembly of the State of South
- The District was created to provide for a publically owned and operated waterworks and sewage disposal system within its service area.
  - 37,800 Population of Hilton Head Island
  - $372M Total Assessed Valuation of real and personal property
- Debt portfolio – slightly > $53 million
  - $10.7M General Obligation Debt
  - $42.3M Revenue Debt
- Issue debt annually
Role of MA for Hilton Head PSD

• Prior experience to date:
  • Traditional finance team members:
    • Primarily Bond Counsel and Underwriter/for Revenue Bonds and MA for GO Bonds
    • Finance Manager
    • PSD Commission Finance Committee Members
    • General Manager
  • The new MA rule has been difficult to understand and small debt issuer’s will be affected when this rule takes effect July 1, 2014
Role of MA for Hilton Head PSD

How will this impact Hilton Head PSD?

• The District has grown accustomed to relying on their existing financing team members (primarily bond counsel and underwriter) to provide financial advice.

• After July 1st, those professionals will be limited in the amount and type of financial advice they may provide, unless they meet one of the exceptions/exemptions.

• Once the rule goes into effect, the types of conversations the District can have with underwriters and other professionals may be more limited in nature than what has traditionally occurred.
Role of MA for Hilton Head PSD

• The new process for me…
• Conduct RFP’s for services to determine scope of services & price and hire an “INDEPENDENT MUNICIPAL ADVISOR”
• To ensure best “deal”
• To assist in telling my “story” to the market
  • Direct link to rating agencies
• Provides technical expertise
  • Provides analysis on rates and market conditions
Role of MA for Hilton Head PSD

- MA can’t serve as Underwriter
  - Buffer between the District & Underwriters
    - Calls like “Did you know you have a refunding opportunity?” get forwarded to MA (if engaged)
    - Impartial – knows “aggressive” bidders for deals
    - No conflict… “no dog in the hunt”
      - Looks out for District’s best interest

- Ensures quality control for bond closings
  - Provides assistance in preparing OS
  - Reviews continuing disclosures filed properly and on time
  - Compares numbers to similar transactions
Role of MA for Hilton Head PSD

• MA will be a valuable member of MY financing team
• A firm that KNOWS my community and what will work and what won’t ….. It’s about the RELATIONSHIP
• Resource for the PSD Commission
  • Confidence and trust built over time
• Helped in developing Debt Management Policy
  • Includes process for handling brokers and underwriters….. Send them to your MA!
• Helped to improve HHPSD Bond Ratings =
  • GO Bonds AA+
  • Revenue Bonds AA
Advice to Small Issuers

When hiring MA…. Do your homework!

- Reputation matters!
- Experience
  - Credentials
  - Make sure MA meets all licensing and regulatory requirements (Broker – Dealer on FINRA.com)
  - Years in practice and knowledge of market
- Check references!
- Determine how well they know your local market?
  - Who represents surrounding entities?
Advise to Small Issuers

- Ensures no conflicts of interest
- Determine what kind of support staff they have?
  - Ability to respond in a timely manner
- Ask Questions!
  - MA’s should be able to answer all questions….even the DUMB ONES
- Ask Questions!
  - Remember...the MA works for YOU!
City of Portland, Oregon

The Municipal Advisor Rule: Why this Matters to Large Issuers

2014 Government Finance Officers Association Conference
May 19, 2014

B. Jonas Biery, Debt Manager
About the City

• 2013 City population = 592,120
• Aaa (Moody’s) unlimited tax bond / issuer rating
• ~85 total debt issues outstanding
  o UTGO
  o Limited Tax Revenue Bonds
  o Water System Revenue Bonds
  o Sewer System Revenue Bonds
  o Urban Renewal Bonds
  o Gas Tax Revenue Bonds
  o Other limited credits (LIDs, SDC-backed, etc)
• Debt may be market-sold or bank-placed, fixed-rate or variable

• City has staff assigned specifically to management of debt issuance and ongoing management
Debt Management Structure

- Debt Manager functions as a centralized and internal “advisor”, working with City bureaus in planning for capital projects
  - Sophisticated understanding of muni market roles and functionality
  - Responsible for management of all market relationships – including MAs & underwriters
  - Rely on direct relationships and contact with underwriting community
    - Gather critical information
    - Supports best bond pricing results
- Mostly use competitive sale method, limited use of negotiated sale method
- Currently under a contractual relationship with a pool of underwriters
  - Contractual relationship is for a period of time (~3 years)
  - Covers all negotiated bond issues
  - City has sole discretion to identify specific underwriting roles on a transactional basis
Use of Municipal Advisor

- Provide support on both transactional and non-transactional projects, at City’s sole discretion
- Supplemental resource to help manage sale or project timing expectations
- Independent resource to provide information and/or confirm assumptions
- Have begun engaging MA more frequently to provide protection as a result of increased regulatory environment
  - Assist with disclosure review
  - Provide pre-sale information & post-pricing research
- MA is only allowed to invoice the City for work that is specifically requested
- City retains decision-making leadership and authority

The City’s expectation is that the MA service provider relationship should remain consistent.
Recent MA Rule Lessons

• Importance of coordination between multiple functional areas
  o Investments and cash management
  o Elected Officials
  o Bureaus with large or unique capital plans
  o Rely on ability to contact market participants to gather critical information

• Update policies and procedures
  o Require MA to be registered
  o Require MA to be independent from underwriting services, and disallow role-switching
    o Avoid multiple City representatives being in official contact with parties subject to the MA Rule

• Communicate changing environment to internal stakeholders

• Communicate City expectations to market participants
  o City retains IRMA under contract (can use IRMA exception)
  o City expects underwriters to remain available for market information
Ongoing Implementation Challenges

- Different institutions appear to have different compliance standards/strategies
- IRMA Exception Letter
  - How best to communicate and distribute
  - Cannot agree to “rely on” MA advice – but can seek and acknowledge
  - Must be worded such that City retains control over MA costs
- How can relationships with multiple MAs be managed appropriately?
- Investment of bond proceeds (if commingled with primary portfolio)
- Early indications that some underwriting firms may be less willing to provide information that provides value to the City
- Costs of regulation that will be borne by the City
  - Administrative costs to facilitate compliance
  - Pass-through costs (via service cost increases) of MA/underwriter regulatory compliance
  - Increased fees paid to MA to ensure regulatory protection to City staff
  - Lost benefit of direct access to some market participants
MA Rule – GFOA Best Practices

- GFOA’s has existing Best Practices which strongly recommend that governments hire a municipal advisor for their bond transactions.

- GFOA revised three of these best practices this year related to this issue –
  - *Selecting and Managing the Engagement of Municipal Advisors*
  - *Selecting and Managing the Engagement of Underwriters for Negotiated Bond Sales*
  - *Selecting and Managing the Method of Sale of State and Local Government Bonds*

- GFOA developed model MA and underwriter exemption language for issuers to use in order to ensure compliance with the rule.
Selecting and Managing the Engagement of Municipal Advisors

- Focused on hiring and management of MAs for bond transactions, and makes recommendations in these areas.
- Alerts issuers to the core components of the MA Rule (Example – MAs have an explicit fiduciary duty to issuers)
- Recommends that issuers hire an MA prior to undertaking a debt financing unless the issuer has sufficient in-house expertise.
- Reminders issuers that while MAs can play a key role on the financing team, issuers remain in control of all final decision making and direction of MA duties.
Selecting and Managing the Engagement of Underwriters for Negotiated Bond Sales

- Focused on hiring and management of underwriters for bond transactions, and makes recommendations in these areas.
- Alerts issuers to the fact the roles of the underwriter and MA are separate, adversarial roles that cannot be provided by the same party.
- Reminds issuers that underwriters do not have a fiduciary duty to issuers.
- Recommends that issuers hire an MA prior to undertaking a debt financing unless the issuer has sufficient in-house expertise.
Selecting and Managing the Method of Sale of State and Local Government Bonds

• Updates made to this Best Practice to discuss the duties, roles and responsibilities of MAs and underwriters under the MA Rule.

• Makes recommendations to state and local governments about selecting a suitable method of sale of bonds, and the use of professionals related to competitive and negotiated bonds.

• Discourages issuers from using a broker-dealer or underwriter to assist in the method of sale selection unless that firm has agreed not to underwrite the transaction.
MA Rule - Resources

- SEC issued FAQ clarification document on January 10, 2014

- GFOA issue brief on rule and related issues
QUESTIONS?

Municipal Advisors Rule