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Analysis of Issues in HR 2827 / S 3620

The financial crisis led to the revelation of massive financial abuses of municipal borrowers by Wall Street banks and derivatives dealers. The most notorious case was in Jefferson County, Alabama, which was driven into bankruptcy due to billions in losses suffered in exploitative swaps deals sold by JP Morgan Chase. But there are hundreds of other examples. The Justice Department has brought over a dozen criminal cases against major banks for manipulation and bid-rigging in the municipal bond markets. Across the country, numerous cities and towns have found themselves trapped in deceptive swaps deals requiring them to pay exorbitant fees.

In response to these problems, Congress passed taxpayer protections in the Dodd-Frank Act. These protections included critical new requirements that those providing financial advice to municipalities register as 'municipal financial advisors' with the Securities and Exchange Commission (SEC). Critically, such financial advisors are obligated to respect a fiduciary duty to respect the best interests of taxpayers and the municipal client in giving financial advice. In December, 2010, the Securities and Exchange Commission issued a proposed rule defining which entities would have to register as such municipal advisors. In part due to heavy lobbying, the rule has not yet been finalized.

The statutory taxpayer protections in the Dodd-Frank Act are now coming under fire in Congress. In September the House passed a bill, HR 2827, on a bi-partisan basis that would greatly weaken municipal advisor rules. The bill has now been introduced in the Senate as S. 3620. The practical effect of this bill would be to exempt individuals working for banks or swap dealers in connection with an underwriting, swaps deal, or sale of a financial product from designation as municipal financial advisors. This would likely be true even if those individuals were in fact giving financial advice to the municipality. Because of the exemption from designation as a municipal advisor, they would not have to follow a fiduciary duty to respect taxpayer interests.

Below is a detailed section-by-section analysis of this legislation. The most important sections are sections 4 through 6, particularly section 5.

Section 1 – Registration of Municipal Securities Dealers

This section exempts financial advice that is provided 'on behalf of' municipal entities from the requirement that it be provided by a registered municipal financial advisor. Advice 'provided to' municipal entities would still be covered.

Section 2 – Municipal Securities Rulemaking Board; Rules and Regulations

This section states explicitly that the Municipal Securities Rulemaking Board (MSRB) has no rulemaking authority to regulate any of the exempted activities listed in Section 5 of this legislation as constituting municipal advice. Note that this could be read to shrink even the pre-Dodd-Frank jurisdiction of the MSRB.

Section 3 – Discipline of Municipal Securities Dealers

This section alters existing statutory language by inserting an explicit statement that all of the activities exempted in Section 5 of this legislation may not be covered by any fiduciary duty requirement promulgated by the MSRB under its municipal advisor authority. In addition, the section explicitly forbids the MSRB from prohibiting municipal advisors from performing principal transactions or receiving commission-based compensation, except that the MSRB may require that such compensation be received in a manner consistent with a fiduciary duty.

Section 4- Definition of Investment Strategies

This section defines 'investment strategies'. These are a key element in the definition of 'municipal financial product', which in turn affects the scope of municipal advisor coverage. Generally 'investment strategies' are meant to cover plans for investment of bond proceeds. The lengthy additions in this section would create significant exemptions to the investment strategies definition:

- Section 15B(e)(3)(A)(i) and (ii) added by this section would narrow the investment strategies definition from the investment of <u>any</u> bond proceeds, to only the investment of those proceeds maintained in specifically segregated accounts or specifically identified to the advisor (in writing) as bond proceeds. This would place the burden on the municipality to trigger the fiduciary duty by its actions in segregating funds or sending written designation of funds to the advisor. This could affect the many municipalities who do not routinely segregate bond proceeds in separate accounts.

- Section 15B(e)(3)(B)(i)-(iv) added by this section would create a number of exemptions from the investment strategy definition for the provision of financial information. The most notable is (iv) which would exempt "the provision of generalized information concerning investments which are not tailored to the specific investment objectives of the municipal entity". This exemption would have to be interpreted by the courts, but would seem to potentially exclude a wide range of investment advice.

Section 5 – Definition of Municipal Advisor

This section is a very comprehensive rewrite of the municipal advisor definition. As such, it is likely to delay the SEC's release of a final municipal advisor rule for significantly longer than the already unacceptably long 2-year delay we have already seen. This kind of statutory change would probably require a reproposal.

The original Dodd-Frank statutory language exempted several categories of activity from the definition of municipal advisor. Section 15B(e)(4)(C) of the Exchange Act (added by Section 975 of the DFA) currently excludes the following parties from the municipal advisor definition:

> ‘‘(C) does not include a broker, dealer, or municipal securities dealer serving as an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933) (15 U.S.C. 77b(a)(11)), any investment adviser registered under the Investment Advisers Act of 1940, or persons associated with such investment advisers who are providing investment advice, any commodity trading advisor registered under the Commodity Exchange Act or persons associated with a commodity trading advisor who are providing advice related to swaps, attorneys offering legal advice or providing services that are of a traditional legal nature, or engineers providing engineering advice”

A key issue is whether the exemption of broker-dealers serving as underwriters (in the first clause) exempts only the direct underwriting activity or advice on complex financial structures that may be related to the underwriting. Past examples of the latter might include variable rate demand obligations, interest rate swaps, etc. Likely there will be more such structures invented in the future. Based on its initial proposal, the SEC is trying to hold the line on some kind of distinction between pure underwriting and complex financial structures that are sold as reducing interest rate costs. The brokers have argued that their existing duties as registered broker-dealers make fiduciary duty unnecessary for any advice. However, in the municipal context these existing duties essentially involve only disclosure. They fall far short of a fiduciary duty and do not even require a suitability standard.

Section 5 replaces the existing exemption clause with a greatly expanded list of nine enumerated exemptions in clauses 15B(e)(4)(C) i through ix. Taking these enumerated exemptions individually:

Clause i exempts any SEC-registered broker dealer to the extent that they are serving or seeking to serve in any capacity whatsoever in an underwriting (lead underwriter, manager, placement agent, etc.). Critically, this clause also expands the exemption to explicitly include any advice that is “related to or in connection with any such activities and not for separate compensation”. This would presumably include any complex financial structures that are portrayed as reducing costs or future interest obligations for the municipality. Very similar language has been interpreted extremely broadly by the SEC in the context of retail investment advice provided by broker-dealers. (In fact, the retail language is narrower than this phrasing, as it refers to ‘reasonably related to’ and I believe it is regulatory and not statutory language).

This 'related to or connected with' language would make it effectively impossible to bring any advice provided by any broker-dealer involved in an underwriting, or even soliciting underwriting business, under the municipal advisor fiduciary duty obligation. (So long as they were not foolish enough to accept separate compensation for such advice).

Note also that the inclusion of 'seeking to serve' in this clause expands the exemption from municipal advisor status to any advice or representations given during a solicitation.

Clause ii exempts investment advisors and is similar to existing law. However, the clause does expand the existing definition somewhat by specifying that investment advice that is 'not of a type that would subject a person to registration' is also exempted, when provided by an investment advisor. We are not certain if this would let through any advice that is not subject to the fiduciary duty already existing under the Investment Advisors Act.

Clause iii exempts all registered swaps dealers and major swaps participants (MSPs) from municipal advisor status and the related fiduciary duty for any advice related to any swaps, plus any additional advice that is 'related to or connected with' swaps-related advice. Once again, the extremely permissive 'related to or connected with' language is used. As it is used to qualify what is already a broad exemption for any advice related to swaps, it seems clear that any advice whatsoever from a swaps entity to a municipality would be exempted from any fiduciary duty, so long as there is even the most tenuous relationship to swaps and so long as no separate compensation is requested.

This clause builds on existing Dodd-Frank language that already exempts registered Commodity Trading Advisors (CTAs) from municipal advisor designation when providing swaps-related advice. However, the CFTC has specifically exempted registered swaps dealers from CTA registration for recommendations given in connection with the purchase of a swap.[1] Because of their advisory relationship commodity trading advisors have a wider range of duties than dealers, and have also in some instances been held to fiduciary duties in case law. So the expansion from registered CTAs to all registered swaps dealers and MSPs in this bill does make a substantive difference.

Finally, it is important to know that in implementing the business conduct standards for special entities passed in Title VII of Dodd-Frank, the regulatory agencies created wide-ranging safe harbors from any 'best interests' duty owed by swaps dealers or MSPs to municipal entities. These safe harbors are based on the exchange of written representations between the dealer/MSP and the municipal entity that the dealer is not acting as a fiduciary.[2] Thus, one should not rely on business conduct standards passed in Dodd-Frank to address issues created by this legislation.

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[1] For a discussion see CFR 9740, in "Business Conduct Standards for Swap Dealers and Major Swaps Participants, Final Rule, RIN 3038-AD25", Federal Register, Volume 77, No. 33, Friday, February 17, 2012.
[2] See CFR 9783 and following, in "Business Conduct Standards for Swap Dealers and Major Swaps Participants, Final Rule, RIN 3038-AD25", Federal Register, Volume 77, No. 33, Friday, February 17, 2012.

Clause iv exempts all banks engaging in any of the activities listed in clauses i – iii (playing any role in an underwriting, giving investment advice, or providing swaps-related advice). Banks are generally exempted from registration under the Investment Advisors Act, and most small to medium size banks would not be required to register as swaps dealers or MSPs thanks to various de minimis rules and exemptions. Thus this clause acts to exempt any banks not swept in to the exemptions based around registration in the previous clauses.

One effect of this clause would be to give banks a strong advantage over investment advisors in providing advice to municipalities, as registered investment advisors would be bound by a fiduciary duty and pay-to-play restrictions while banks would not be. As rules are currently written, if this law were passed I believe it would create a bank loophole even for pay to play restrictions.

The SEC's inclusion of banks, including community banks, in municipal advisor coverage created substantial political pushback. However, the decision by a municipality to place tax or bond proceeds in an account or CD at a bank rather than using another investment strategy can have serious financial implications.

Clause v exempts any person 'subject to regulation by a State insurance regulator providing insurance products or services or providing any advice that is related to or in connection with any such activities and not for separate compensation'. An important question here is whether various financial guarantee products often sold to municipalities by the financial arms of insurance companies could be swept in under 'insurance products or services', or whether advice related to such products would be included under the 'any advice related to' exemption. The broad phrasing of the 'related to or in connection with' exemption suggests that it could be.

Clause vi exempts accountants providing any advice 'related to or in connection with' usual and customary accounting services, including attestation or review services or opinion letters related to underwriting. If the broad exemption here would allow generalized advice by accountants (beyond just a traditional attestation letter for an underwriting) this exemption could significantly expand exemptions from municipal advisor protections.

Clauses vii and viii exempt attorneys providing traditional legal advice and engineers providing engineering advice. These exemptions are already there in the existing Dodd Frank text.

Clause ix exempts any elected or appointed member of the governing body of a municipal entity. The inclusion of elected or appointed board members is of course the issue that created a firestorm of criticism in the SEC's initial municipal advisor definition. Fixing this problem takes only about four lines out of the several hundred lines of statute in this bill.

Section 6 – Definition of Solicitation of a Municipal Entity Or Obligated Person

Solicitation of municipal entities is of course the area where many of the worst pay-to-play scandals have taken place, as intermediaries steer municipal investments toward funds or institutions that they have financial relationships with. The Dodd-Frank Act addressed this by making third-party solicitation of municipal entities on behalf of brokers, dealers, or investment advisors one of the areas covered by the municipal advisor designation.

This section would specify that any communications made to a municipality 'on behalf of a fund or other collective investment vehicle' would not be deemed to be on behalf of any investment adviser that advises or manages the fund. The definition of solicitation created by the Dodd Frank Act and currently in Section 15B(e)(9) of the Exchange Act (15 USC 78o-4(e)(9)) requires that in order to meet the definition of solicitation any sales approach must be made 'on behalf of' a broker, dealer, municipal securities dealer, investment advisor, or municipal advisor. Specifying that a solicitation made on behalf of a fund cannot be deemed made on behalf of the investment advisor who manages the fund would appear to create a large loophole in this definition. It appears that anyone making solicitations on behalf of a fund or collective entity could evade municipal advisor designation or the resulting fiduciary duty, since they were not soliciting 'on behalf of' an investment advisor. This would exempt these third party solicitors from pay to play rules passed by the MSRB under their municipal advisors authority.

It is still possible for municipal pay-to-play restrictions passed by the SEC under the Investment Advisors Act could still remain in effect, however these only bind the investment advisor and not the third party solicitor. In addition, the SEC passed certain exemptions to the Investment Advisors Act pay-to-play restrictions that were designed to accommodate the municipal advisors restriction; these would have to be revisited.