Dodd-Frank Act and the Role of the Municipal Advisor

Wisconsin Government Finance Officers Association – Winter 2011

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Summary

New rules and regulations designed to protect governmental entities that issue debt obligations are in force and will effect both the issuers as well as the professionals who serve the municipalities.

Effect on Professional Services Industry

- Both financial advisors and underwriters will have new and extensive disclosure responsibilities to their municipal clients.
- Additionally, the line separating the role and duties of the financial advisor and the underwriter will be more clearly defined.

Effect on Governmental Entities

- Governmental entities that issue debt need to understand the new rules (existing, proposed, and future), as they will be expected to acknowledge the above referenced disclosures in writing.
- The municipality may need to reevaluate their relationship with their financial advisor or underwriter in light of the mentioned disclosures.

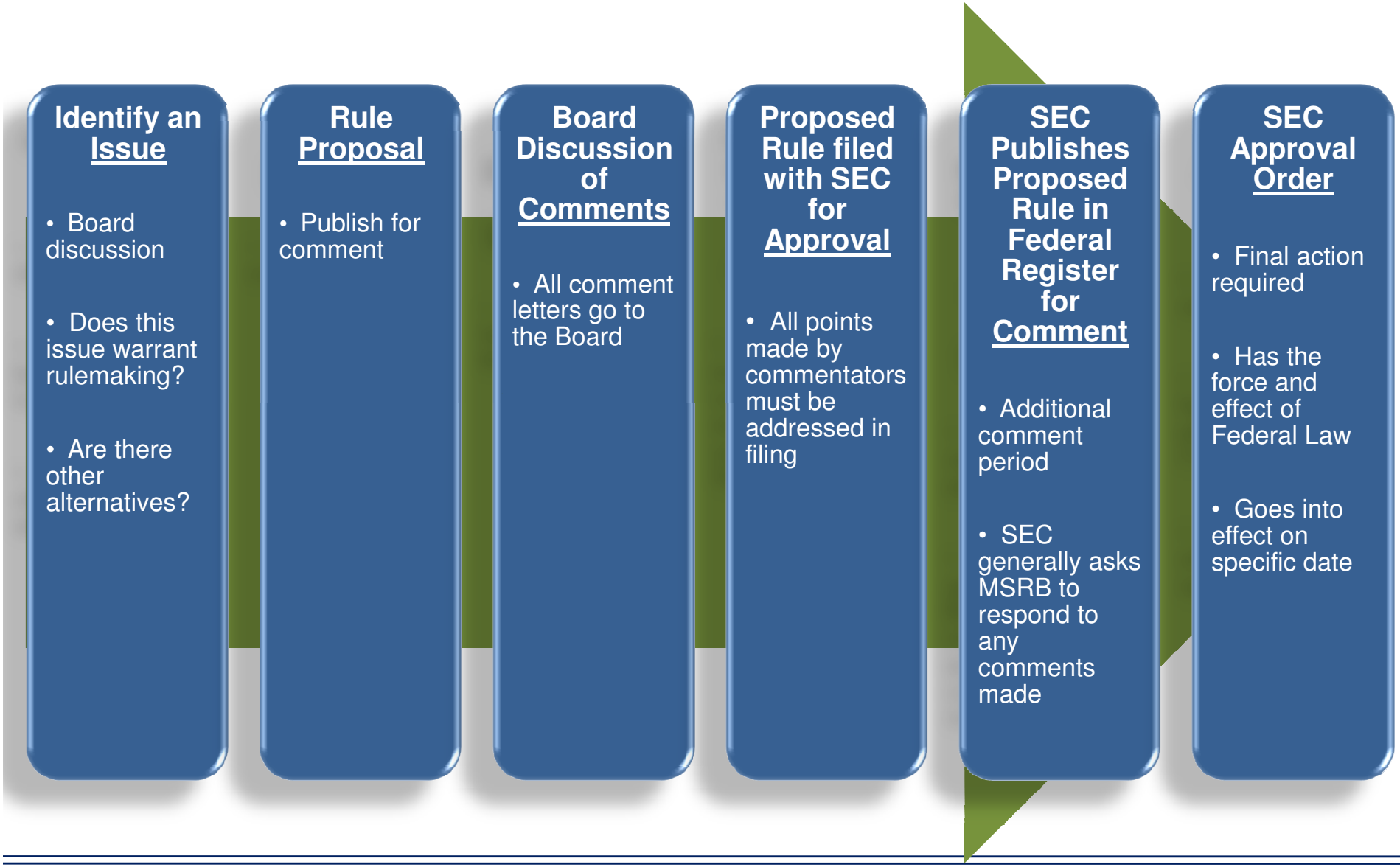
The Role of the MSRB

- Municipal Securities Rulemaking Board ("MSRB")
- A self-regulatory organization that is subject to SEC oversight
- Seeks to promote a fair, efficient and transparent municipal market
- Established in 1975 to protect municipal market investors by regulating municipal securities dealers
- Began operating the Electronic Municipal Market Access (EMMA) system in 2008, which is a centralized collection of municipal disclosure documents and trade data that provides access to key market information free of charge
- MSRB's website is: http://www.msrb.org/
- EMMA's website is: http://emma.msrb.org/

Dodd-Frank Wall Street Reform and Consumer Protection Act

- Dodd-Frank was signed into law July 21, 2010
- Most significant piece of municipal legislation since 1986
- Expanded both the MSRB's mission and jurisdiction
- Before Dodd-Frank, the MSRB's mission was to protect investors and regulate broker dealers (i.e., the underwriters).
- After Dodd-Frank, MSRB's mission is to protect both investors and municipal entities by regulating broker-dealers and municipal advisors.

The Rulemaking Process



MSRB Municipal Advisor Regulation

- MSRB is adopting a comprehensive set of rules for municipal advisors to:
  - Prohibit fraud and manipulative practices
  - Establish fiduciary obligation to municipal entity clients
  - Require fair treatment of investors, municipal entities and obligated persons
  - Restrict real and perceived conflicts of interest

Pending MSRB Rulemaking Initiatives

Certain MSRB rules, both existing and proposed, that are intended to protect the municipal issuers of debt are presented below.

Municipal Advisor	Underwriter Disclosure	Underwriter Role Switching
G-36 Proposed	G-17 Existing	G-23 Old
	G-17 Proposed	G-23 Revised
	G-17 Amendment No. 2	

G-36 Fiduciary Duty for Municipal Advisor

Proposed Rule G-36

- Dodd-Frank established a fiduciary duty for municipal advisors but without a definition.
- In August 2011, the MSRB filed proposed Rule G-36 on fiduciary duty of municipal advisors to their governmental clients, and a proposed interpretive notice concerning the application of proposed Rule G-36.
- Rule G-36 requires that municipal advisors be subject to a fiduciary duty which requires an advisor to:

1. **Exercise care in performing its responsibilities (Duty of Care)**
2. **Deal honestly and in good faith with the municipal entity and act in the municipal entity's best interest without regard to financial or other interests of the advisor. (Duty of Loyalty)**

G-36 Fiduciary Duty for Municipal Advisor (Duty of Care)

Proposed Rule G-36

The Duty of Care can be summarized as follows:

1. **Necessary Qualifications**
   - The advisor must possess the degree of knowledge and expertise needed to provide the municipal entity with informed advise.

2. **Consideration of Alternatives**
   - The advisor has a duty to investigate and advise the municipal entity of alternatives to the proposed financing if those alternatives would better serve the interests of the municipal entity.

3. **Duty of Inquiry**
   - An advisor must make a reasonable inquiry as to the facts that are relevant to a municipal entity's determination of whether to proceed with the course of action.

4. **Advisor Not a Guarantor**
   - Acting competently, making inquiries, and considering feasible alternatives does not make the municipal advisor guarantor of a successful financing.

G-36 Fiduciary Duty for Municipal Advisor (Duty of Care)

Proposed Rule G-36

Duty of Care - limitations:

- **Permissible Limitations on Scope of Engagement**
  - Municipal advisors may be retained for limited engagements and limit the scope of the engagement to which their fiduciary duty applies.
  - In some cases, a municipal entity may have already reached a decision that a particular type of financing or financial product is appropriate for it and not find it necessary for the advisor to advise it on appropriateness. In that case, under Rule G-36 the advisor's engagement must reflect the limitations on its role.
  - In either case, these limitations must be disclosed prior to the commencement of the engagement.

G-36 Fiduciary Duty for Municipal Advisor (Duty of Loyalty)

Proposed Rule G-36

The Duty of Loyalty requires the advisor to deal honestly and in good faith with the municipal entity and act in the municipal entity's best interest without regard to financial or other interests of the advisor. A more detailed discussion on Duty of Loyalty follows.

Conflicts of Interest

- **Disclosure Obligations**. Under G-36 a municipal advisor must disclose all material conflicts of interest of which it is aware. The following are some of the types of conflicts that must be disclosed by the municipal advisor.

  i. Payments by municipal advisors made to obtain or retain municipal advisory business

  ii. Payments from third parties to the municipal advisor in relation to the engagement

  iii. Payments from third parties to enlist the advisor's recommendation of their services

  iv. A financial relationship between the advisor and any other principal in the transaction

  v. Form of Compensation for the municipal advisory engagement (Appendix A)

  vi. Other relationships that might impair the advisor's ability to act in the best interest of the municipal client

G-36 Fiduciary Duty for Municipal Advisor (Duty of Loyalty)

Proposed Rule G-36

Duty of Loyalty (continued):

Conflicts of Interest (continued)

- **Informed Consent**. The municipal advisor **must receive written consent to its conflicts by an official of the municipal entity that the municipal advisor reasonably believes has the authority to bind the municipal entity by contract** with the municipal advisor before the municipal advisory engagement begins or, in the case of conflicts discovered or arising after the municipal advisory engagement has begun, before the municipal advisor may continue to provide such services.

- **Unmanageable Conflicts**. Note that some conflicts of interest are considered "Unmanageable Conflicts" and regardless of client notification. Examples of unmanageable conflicts that a municipal advisor cannot engage in include:
  - Kickback arrangements
  - Payments made by third parties that influence the advice of the municipal advisor

G-36 Fiduciary Duty for Municipal Advisor (Duty of Loyalty)

Proposed Rule G-36

Duty of Loyalty (continued)

Compensation

- **Excessive Compensation**. A municipal advisor's compensation may be so disproportionate to the nature of the municipal advisory services performed as to indicate that the municipal advisor is not acting in the municipal entity's best interests as required by Rule G-36. Such excessive compensation would constitute a violation of the municipal advisor's duty of loyalty, even if such compensation has been disclosed.

- **Forms of Compensation**. a municipal advisor must provide **written disclosure** to its municipal entity client of what the amount (in dollars and to the extent it can be quantified) of its direct compensation and indirect compensation (e.g., amounts paid to affiliates) from the engagement will be, or is projected to be, as well as the scope of services to be provided for that compensation. Additionally, the municipal advisor must provide **written disclosure** to its client of the conflicts of interest associated with various forms of compensation, including the form of compensation applicable to its engagement.

G-36 Fiduciary Duty for Municipal Advisor (Duty of Loyalty)

Proposed Rule G-36

Conflicts of interest presented by various forms of compensation (Appendix A)

- **Fixed fee**. This form of compensation presents a potential conflict of interest because, if the transaction requires more work than originally contemplated, the advisor may suffer a loss. Thus, the advisor may recommend less time-consuming alternatives, or fail to do a thorough analysis of alternatives.
- **Hourly fee**. This form of compensation presents a potential conflict of interest if the client and the advisor do not agree on a reasonable maximum amount at the outset of the engagement, because the advisor does not have a financial incentive to recommend alternatives that would result in fewer hours worked.
- **Contingent fee**. This form of compensation presents a potential conflict because the advisor may have an incentive to recommend unnecessary financings or financings that are disadvantageous to the client.
- **Retainer agreement**. This form of compensation presents a potential conflict of interest because, a retainer is generally calculated on a fixed fee or hourly basis (see above).
- **Per bond fee**. This form of compensation presents a conflict of interest because the advisor may have an incentive to advise the client to increase the size of the securities issue or modify the derivative for the purpose of increasing the advisor's compensation.

G-17 Fair Dealing Duties of Underwriters to Issuers

Existing and Proposed MSRB Rule G-17

- MSRB continues to regulate municipal securities dealers and has placed renewed emphasis on their duties to issuers in light of new municipal entity protection mission.

- MSRB's "fair dealing" rule (MSRB Rule G-17) requires underwriters and other dealers to deal fairly with municipal entities. This is an existing rule and quite succinct with respect to issuers.

  – "In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

- MSRB has filed documents with the SEC that would provide interpretive notice concerning the application of Rule G-17 to underwriters of municipal securities.

1. **Original Proposed Rule Change to G-17 (filed with SEC August 22, 2011)**

2. **Amendment No. 2 to Proposed Rule Change to G-17 (filed with SEC Nov. 10, 2011)**

G-17 Fair Dealing Duties of Underwriters to Issuers

Original Proposed Rule Change to G-17

- In August 2011, the MSRB proposed guidance on fair dealing duties of underwriters to issuers, including:
  - Material misrepresentations or omissions are prohibited
  - Heightened disclosures to issuers about material risks and terms of complex new issue financing
  - Disclosure to issuer of conflicts of interest
  - New issue price an underwriter pays to an issuer must be fair and reasonable
  - Underwriter compensation must not be excessive

G-17 Fair Dealing Duties of Underwriters to Issuers

Amendment No. 2 to Proposed Rule Change to G-17

- In November 2011, the MSRB proposed Amendment No. 2 to Rule G-17
- Amendment No. 2 would provide for robust disclosure by an underwriter as to its role, its compensation, and actual or potential material conflicts of interest.

Role of the Underwriter/Conflicts of Interest

- In a negotiated underwriting, the underwriter's Rule G-17 duty to deal fairly with an issuer of municipal securities requires the underwriter to make certain disclosures to the issuer to clarify its role in an issuance of municipal securities and its actual or potential material conflicts of interest with respect to such issuance.

G-17 Fair Dealing Duties of Underwriters to Issuers

Amendment No. 2 to Proposed Rule Change to G-17

- Disclosures Concerning the Underwriter's Role. The underwriter must disclose that:

  i. Municipal Securities Rulemaking Board Rule G-17 requires an underwriter to deal fairly at all times with both municipal issuers and investors;

  ii. the underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer;

  iii. unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests;

  iv. the underwriter has a duty to purchase securities from the issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors at prices that are fair and reasonable; and

  v. the underwriter will review the official statement for the issuer's securities in accordance with, and as part of, its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction.

G-17 Fair Dealing Duties of Underwriters to Issuers

Amendment No. 2 to Proposed Rule Change to G-17

- The underwriter must not recommend that the issuer not retain a municipal advisor
- Disclosure Concerning the Underwriter's Compensation
  - The underwriter must disclose to the issuer whether its underwriting compensation will be contingent on the closing of a transaction. It must also disclose that compensation that is contingent on the closing of a transaction or the size of a transaction presents a conflict of interest, because it may cause the underwriter to recommend a transaction that it is unnecessary or to recommend that the size of the transaction be larger than is necessary.
- Other Conflicts Disclosures

i. any payments described under "Conflicts of Interest/ Payments to or from Third Parties";

ii. any arrangements described under "Conflicts of Interest/Profit-Sharing with Investors";

iii. any incentives for the underwriter to recommend a complex municipal securities financing and other associated conflicts of interest (as described under "Required Disclosures to Issuer").

G-17 Fair Dealing Duties of Underwriters to Issuers

Amendment No. 2 to Proposed Rule Change to G-17

- Timing and Manner of Disclosures
  - All of the foregoing **disclosures must be made in writing to an official of the issuer that the underwriter reasonably believes has the authority to bind the issuer by contract** with the underwriter. Disclosures must be made in a manner designed to make clear to such official the subject matter of such disclosures and their implications for the issuer. Other disclosures concerning the role of the underwriter and the underwriter's compensation generally must be made when the underwriter is engaged to perform underwriting services (e.g., in an engagement letter), not solely in a bond purchase agreement.
- Acknowledgement of Disclosures
  - The underwriter must attempt to receive written acknowledgement (other than by automatic e-mail receipt) by the official of the issuer of receipt of the foregoing disclosures. If the official of the issuer agrees to proceed with the underwriting engagement after receipt of the disclosures but will not provide written acknowledgement of receipt, the underwriter may proceed with the engagement after documenting with specificity why it was unable to obtain such written acknowledgement.

G-23 Dealer Financial Advisors (Role Switching)

Revised Rule G-23

One of the first changes to municipal finance resulting from the Dodd-Frank Act is an amendment to MSRB Rule G-23, which became effective on November 27, 2011.

Prior to Revised Rule G-23, a firm could serve as both financial advisor and underwriter on the same transaction as long as the firm received permission from the issuer.

Competitive Bid Sales

Old Rule G-23 - A broker dealer could receive the issuer's permission to bid the same terms and conditions as all other underwriters. Granting permission to bid on a competitive sale did not end the broker dealer's financial advisory relationship with the issuer.

New Rule G-23 – A broker dealer is prohibited from acting as a financial advisor and bidding on the issuer's bonds during a competitive bid sale. An issuer must determine whether it wants the broker dealer to be an advisor or an underwriter – as the two roles are mutually exclusive on for debt issues sold via competitive bid.

G-23 Dealer Financial Advisors (Role Switching)

Revised Rule G-23

Negotiated Sales

Old Rule G-23 - A broker dealer could serve as financial advisor on an issue and then underwrite the same issue provided that the underwriter took the following four steps:

i. Underwriter terminates the financial advisory relationship in writing,

ii. Underwriter receives acknowledgement from the issuer to the new role,

iii. Underwriter discloses to the issuer that there may be conflicts of interest, and

iv. Underwriter discloses to the issuer the source and anticipated amount of all compensation the dealer will receive as underwriter.

New Rule G-23 – The above option is no longer available. Assuming that the issuer would like to sell bonds on a negotiated basis, there are three options:

i. Retain no financial advisor and rely on the advice of the underwriter "acting as underwriter."

ii. Require that your underwriter act as a financial advisor and represent your interests in a negotiated transaction with a separate underwriting firm.

iii. Retain a financial advisor to represent your interests in negotiating with existing underwriter.

Responsibilities of Municipal Advisor and Underwriter

Municipal Advisor

Proposed rule (G-36) would require municipal advisors to have a Fiduciary Responsibility to the issuers.

- Duty of Loyalty
- Duty of Care

New disclosure on conflicts of interest, particularly with respect to compensation.

Underwriter

New rule (G-23) do not allow a broker-advisor to act as a financial advisor during a transaction and later switch to an underwriting role.

Proposed rules (G-17) would create significant new disclosures to the issuers regarding the underwriter's:

- Role in the transaction
- Conflicts of interest