

IGFOA Annual Conference

The Changing MSRB Regulatory Environment

September 14, 2015

Presentation by:

Robert W. Baird & Co., Inc.
John Piemonte, Vice President
300 East Fifth Avenue, Suite 200
Naperville, IL 60563
(630) 778-2633
jpiermonte@rwbaird.com

Anthony Miceli
Speer Financial, Inc.
One North LaSalle Street, Suite 4100
Chicago, Illinois 60602
(312) 529-5881
amiceli@speerfinancial.com

Kent M. Floros
Chapman and Cutler LLP
111 West Monroe Street
Chicago, Illinois 60603
(312) 845-3723
floros@chapman.com

Robert W. Baird & Co. Inc. is providing this information to you for discussion purposes. The materials do not contemplate or relate to a future issuance of municipal securities. Baird is not recommending that you take any action, and this information is not intended as "advice" within the meaning of Section 15B of the Securities Exchange Act of 1934 or the rules thereunder. All investments carry some level of risk including loss of principal. Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Preservation of principal and regular income are dependent upon the creditworthiness of the bond's issuer.

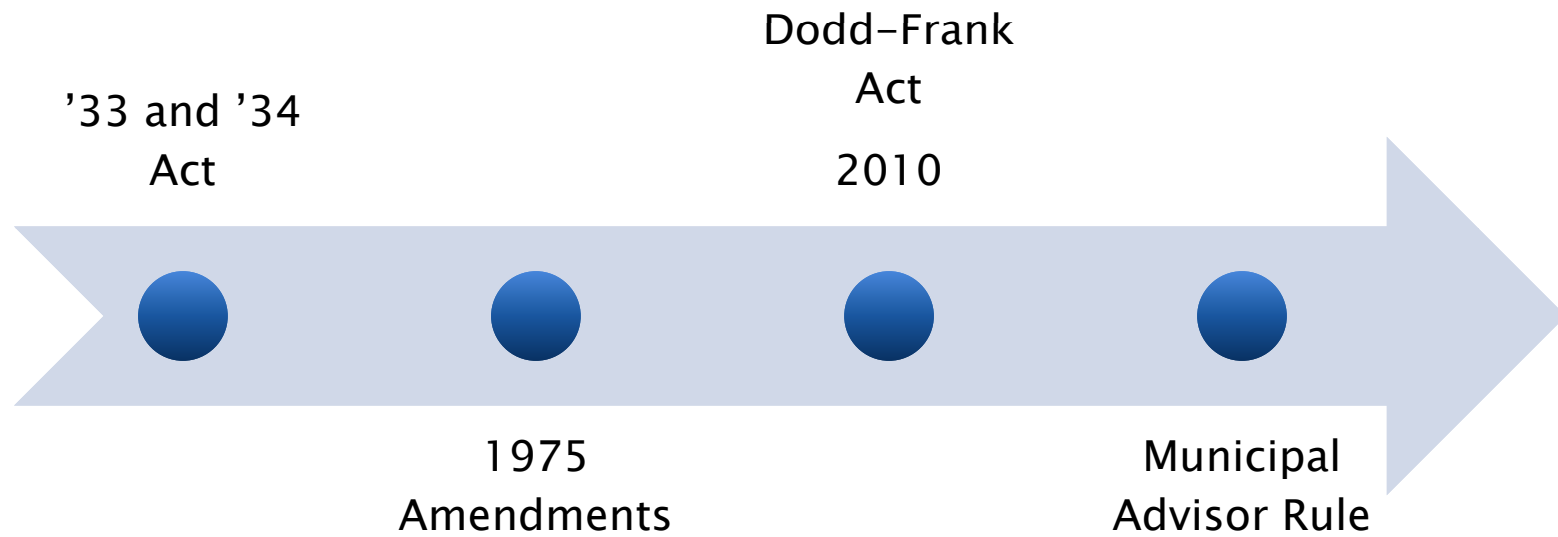


Overview

- ▶ Description of Regulatory Environment and Dodd–Frank
 - Kent Floros, Chapman and Cutler LLP
- ▶ Municipal Advisors and their Fiduciary Duties
 - Anthony Miceli, Speer Financial, Inc.
- ▶ Impact of Dodd–Frank and the MA Rule on Underwriters
 - John Piemonte, Robert W. Baird & Co.

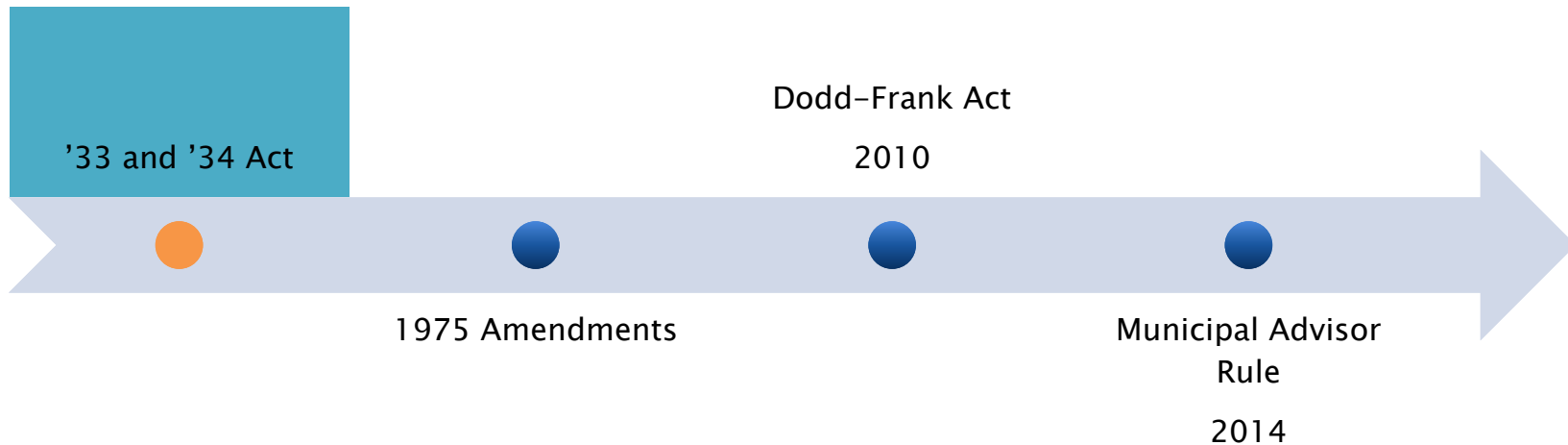


The Regulatory Environment for Municipal Securities

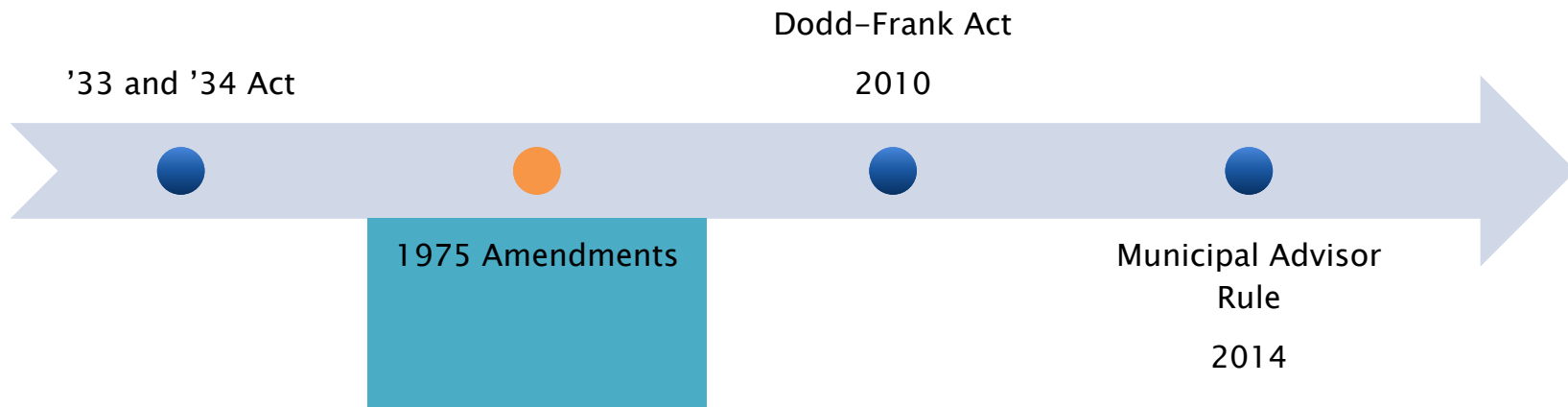


This is just a partial examination of the regulatory environment
Concerns the regulations surrounding how professionals
interact with issuers

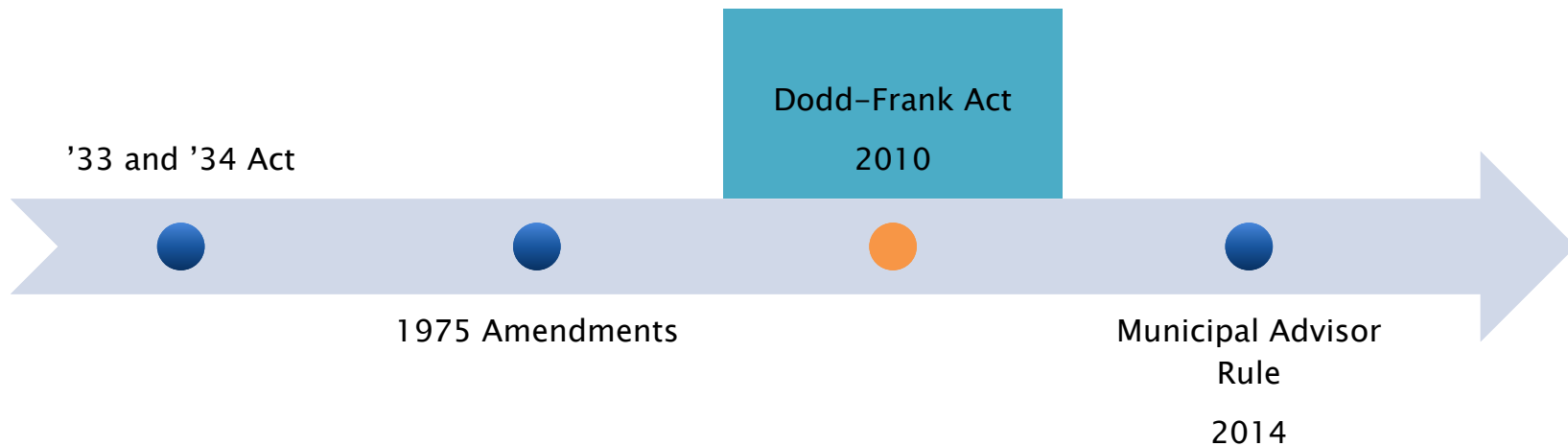




- ▶ '33 and '34 Acts establish foundation
 - Municipal securities and issuers exempt from many provisions
 - Anti-fraud provisions remain applicable



- ▶ Substantial impacts for Municipal Dealers
 - Creation of MSRB
 - Transfer of additional powers to the SEC
 - Registration of Municipal Dealers
- ▶ Tower Amendment



- ▶ 2010 Response to the Great Recession
 - Sweeping changes to financial system
- ▶ Specific Municipal Market Impacts
 - Creates SEC Office of Municipal Securities
 - Enhances role of MSRB
 - Regulates previously unregulated participants

SEC Office of Municipal Securities

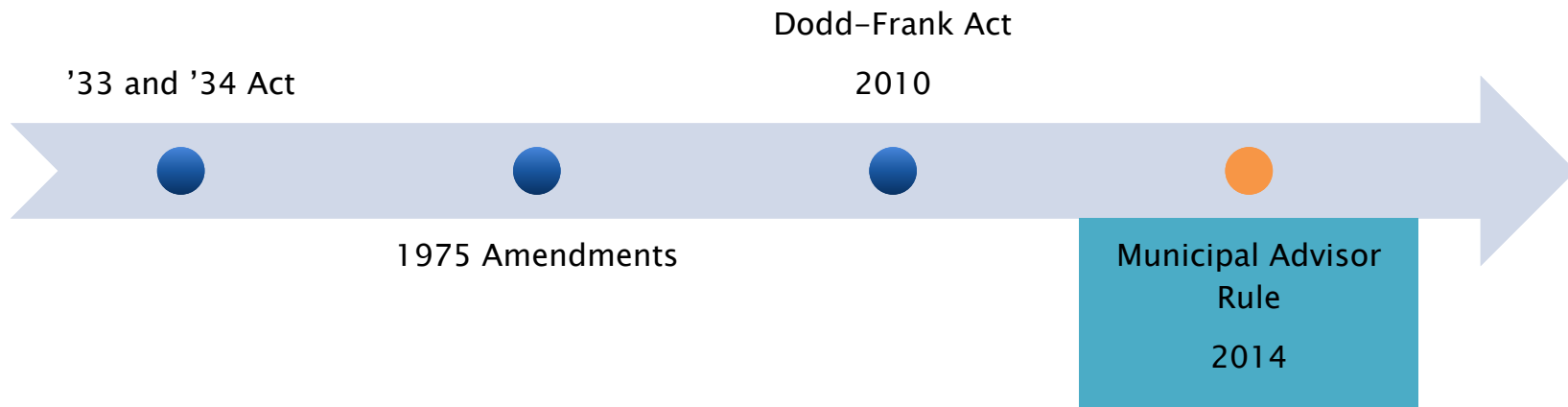
- Administers SEC rules regarding municipal securities
 - Includes impacts on Municipal Dealers, issuers and investors in municipal securities
 - Separate from the enforcement division
- Liaison between SEC and MSRB
- Director of OMS reports directly to SEC Chairman



The MSRB After Dodd-Frank

- Board of directors reconstituted
 - Goal is to ensure independence from Municipal Dealers
 - 8 members of 15 member board must now be independent
- Expanded Rulemaking Authority
 - Municipal financial products
 - Protection of issuers
 - Municipal Advisors
- Charged with:
 - Promulgating rules regarding advice given to issuers
 - Setting professional standards and proficiency tests
 - Ameliorate regulatory burden on small M.A.s





- ▶ Municipal Advisor Rule Adopted in 2014
 - Registration
 - Imposition of Fiduciary Duties on “Municipal Advisors”

Municipal Advisor Rule

- Establishes the conduct that requires registration
- M.A. Rule provides that:
 - Without an exemption, only a registered M.A. may provide certain advice
 - Exemptions and exclusions allow for non-M.A. to provide some advice
 - M.A.s are prohibited from acting in certain capacities with respect to a municipal securities transaction



Dodd Frank and the Reasons for MA Regulation.

- ▶ During the Financial Crisis a number of municipalities suffered losses as a result of advice from unregulated intermediaries (mostly related to complex derivative products).
- ▶ Dodd Frank established federal regulations requiring MAs to register with the SEC, deeming them to owe a fiduciary duty to their municipal entity clients and granting the MSRB rulemaking authority over them.
- ▶ MA Rule is intended to “enhance the oversight of MAs and their activities, aid municipal issuers in choosing MAs, and provide greater transparency to an issuer when it is engaging in transactions or investments with MAs”.



Under the New Regulations - What Must MAs Do?

- ▶ MAs must register with the SEC and the MSRB.
 - Includes the filing of a MA registration form detailing the MAs activities, ownership, affiliations, past legal actions, and more.
- ▶ MAs must pay annual firm fees and individual MA Representative fees to the MSRB to help pay for their regulation.
- ▶ MAs are subject to substantially the same disciplinary rules and bookkeeping requirements as municipal securities dealers.
- ▶ The MSRB has finalized Rule G-44 which sets forth supervisory and compliance obligations comparable to that imposed on municipal securities dealers.



The MSRB.

- ▶ The MSRB is in the process of adopting rules for MAs that will impose a comprehensive regulatory regime, similar to that imposed on municipal securities dealers.

- ▶ The MSRB's rules will cover the following areas:
 - Training
 - Supervision
 - Record Keeping
 - Comprehensive Code of Conduct
 - Prohibited Conduct
 - Compliance Exams



What Duties Do MAs Owe to their Issuer Clients?

- ▶ MAs owe a fiduciary duty to their municipal clients.
- ▶ MAs owe a fair dealing obligation to their obligated person clients. This obligation generally follows the Rule G-17 obligation to “deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice”.
- ▶ MA duties begin once an employee of the MA is providing, or is engaged to provide, MA services.



Fiduciary Duty.

- ▶ A major component of the MA Rule is the establishment of a Fiduciary Duty on MAs to their municipal clients.
- ▶ Fiduciary Duty:
 - Requires the MA to act in the best interest of its client and to put the client's interests ahead of its own.
 - Fiduciary duty includes the Duty of Care and the Duty of Loyalty.



Duty of Loyalty.

- ▶ Deal honestly and in good faith with your municipal client and act in the client's best interest without regard to the financial or other interests of the MA firm or MA individual.
- ▶ Disclose any conflicts of interest at the onset of an engagement or that arise during an engagement.
- ▶ Disclose any material disciplinary actions or legal disclosures to a client.
- ▶ Abstain from any prohibited conduct.
- ▶ Do not charge excessive compensation.



Duty of Care.

- ▶ Act competently and possess the necessary qualifications.
- ▶ MAs must not undertake an engagement for which they do not have the degree of knowledge and/or expertise to provide the client with informed advice.
- ▶ MAs must determine if a transaction is suitable for a client.
- ▶ “Suitability” should take into account the following factors:
 - Risk tolerance.
 - Financial circumstances.
 - Objectives.
 - Tax status.
 - Any other material information discovered after a reasonable inquiry (Duty of Inquiry).
- ▶ The suitability determination requires the MA to “know your client”.



Duty of Care (continued).

- ▶ The Duty of Care also requires:
 - The MA undertake a reasonable investigation to determine that any recommendation is not based on materially inaccurate or incomplete information.
 - Have a Reasonable Basis for the following:
 - Advice.
 - Representations made in certificates.
 - Any information provided to the client or other parties when preparing the official statement or other disclosure document.



Roles Defined: MA / Underwriter

- ▶ Any person who solicits and/or provides **advice** to, or on behalf of, a municipal entity or obligated person regarding a municipal financial product or an issuance of municipal securities is considered to be a Municipal Advisor and owes a fiduciary duty to the municipal entity.
- ▶ Firms seeking appointment as underwriter on a municipal securities issuance must be careful to rely on certain exemptions from the MA Definition in order to provide underwriting services on a transaction.
- ▶ Firms acting as underwriter cannot also act as municipal advisor on the same issuance of municipal securities as they cannot have a fiduciary relationship with the issuer.



How are the Activities of MAs Affected?

- ▶ MAs must provide written evidence of a Municipal Advisory Relationship.
- ▶ At the onset of a relationship, MAs must also disclose the following:
 - Any material conflicts of interest.
 - The scope of services to be performed and any limitations.
 - The form and basis for compensation.
 - The date, or triggering event, and/or means for termination of the MA relationship.
- ▶ These new requirements may require a new or amended/supplemental contract or engagement letter between an issuer and a MA.



How are the Activities of MAs Affected? (continued)

- ▶ With the requirements set forth by the Duty of Care, MAs may also be providing issuers with additional correspondence during the course of an engagement.
 - Information on the material risks, benefits and characteristics of the transaction or product.
 - Basis for the MA's suitability determination.
 - Whether the MA investigated any other reasonably feasible alternatives.
- ▶ Overall, the general scope of services between a MA and its client and the general functions performed by an MA remain unchanged.
 - Unless revised by the MA in its contract or engagement letter and agreed to by the client.



Recommended Reading.

- ▶ GFOA Issue Brief: SEC Municipal Advisor Rule.
- ▶ GFOA Best Practices:
 1. Selecting and Managing the Engagement of Municipal Advisors (2008 and 2014) and
 2. Selecting and Managing the Engagement of Underwriters for Negotiated Bond Sales (2008 and 2014).
- ▶ See Debt Management section at:
www.gfoa.org/best-practices.



How does Dodd-Frank impact our underwriting customers?

- Dodd-Frank requires Banks to conduct two forms of credit risk analysis before and after the purchase of municipal bonds.
 - Banks have difficulty with credit monitoring due to limited resources and staff.
- 1. Prior to purchase of bonds, banks need to have proof of pre-purchase analysis.
 - Allowed to utilize 3rd party research.
 - To assist our bank clients, Baird creates a two page pre-purchase analysis to include the security of the bonds and financial data of the issuer for all bank-qualified bonds sold via negotiated sale.
- 2. Following purchase of bonds, Banks need to conduct ongoing portfolio review of risk (annual basis).
 - Few firms offer this service.
 - Regulators have been lenient as long as the banks can demonstrate good faith effort was made.
- As a result of the Act, banks are becoming leery of bank-qualified paper because of the regulatory hurdle.
 - Removes municipal bonds from “highly liquid” category hurting bank capitalization
 - Could impact the number of banks willing to buy BQ paper in the future.
- What can Municipalities do to help mitigate this issue?
 - Transparent and timely filing of information on the MSRB’s EMMA website.



The Municipal Advisor Rule (“MA Rule”)

- Underwriters Duties and Responsibilities to Clients:
 - While an underwriter does not have a fiduciary duty to an issuer under the current federal securities laws, it does have a commercial duty to deal fairly with both its issuer client and bond investors. This means that an underwriter has a duty to purchase securities from the issuer at a fair and reasonable price and sell those securities to investors at prices that are fair and reasonable.
 - Once engaged by an issuer, an underwriter may provide incidental financial advisory services, including advice as to the structure, timing, terms and other matters concerning the issuance of the relevant bonds/securities. When providing such services it does so in its capacity as underwriter and not as the issuer’s municipal advisor.



Financial Advisor vs Underwriter – What’s the Difference?

	Financial Advisor	Underwriter
Formal Primary Role:	Provide municipal advisory services with respect to the issuance of municipal securities	Purchase securities from the issuer and resell them to investors both at fair and reasonable prices
Registered as:	Municipal Advisor with SEC & MSRB (required as of July 1)	Broker/Dealer with SEC and MSRP
Limitations:	Cannot serve as underwriter or placement agent for the <u>proposed offering</u> (MSRB Rule G-23)	May provide incidental financial advisory services regarding the proposed offering in its capacity as underwriter and within the scope of the underwriting only after it is engaged, such as advice as to the terms, timing, structure and similar matters concerning the proposed offering
Duties:	<ul style="list-style-type: none"> Has a fiduciary duty and must act in the best interest of the issuer which includes the duty of care and duty of loyalty 	<ul style="list-style-type: none"> Deal fairly at all times with both municipal issuers and investors Purchase securities from the Issuer at a fair and reasonable price and sell those securities to investors at prices that are fair and reasonable Review the official statement Does not have a fiduciary duty to the issuer (obligor) under the federal securities law and is therefore not required by federal law to act in the best interests of the issuer (obligor) without regard to its own financial or other interests
Fees:	Terms set forth in an agreement negotiated and entered into in connection with the issuance	Terms determined by underwriting discount that will be set forth in the engagement letter or bond purchase agreement to be negotiated and entered into in connection with the issuance of the securities



What are underwriters doing to address the new role definitions and regulations?

- Underwriters have established policies and procedures to address the MA Rule which include such things as:
 - Compliance/legal driven templates created for underwriting engagement letters and financial advisory contracts.
 - Compliance/legal drive disclosures included on all outgoing correspondence prior to engagement defining the role sought.
 - Compliance/legal reviews all correspondence prior to formal engagement to confirm information vs. advice if seeking role as underwriter.
 - Creation of templates for presenting hypothetical structuring numbers, information on the company, among other things.
 - Appointment of Compliance officer to oversee the registration of MAs and implementation of these policies/procedures.
- Hosted numerous staff meetings to educate the team of the new rule, its requirements, its consequences, information vs. advice, and the firm's policies/procedures.



What are the circumstances that allow an underwriter to provide advice to an issuer?

- An underwriter can provide advice with respect to a possible issuance of municipal securities without being a municipal advisor if one of the following exemptions applies.
- 1. **Underwriter Exemption.** A firm serving as underwriter can provide advice within the scope of the underwriting, which includes advice regarding structure, timing, terms, ratings, bond insurance, and other similar matters.
 - Must be engaged by the client to serve as underwriter for the relevant issuance(s).
 - May be established through an engagement letter that shows an affirmative decision by the client to select the firm as underwriter for the issuance(s) and provides disclosure to the client about the role of an underwriter (as required by MSRB Rule G-17).
 - The engagement letter may either take the form of a formal contract or a less formal letter that is preliminary or non-binding, terminable at will, and subject to formal approval or other conditions.

Inside Scope of Underwriting	Outside Scope of Underwriting
<ul style="list-style-type: none">• Advice on structure, timing and terms of financing.• Assistance in preparing official statement.• Assistance in preparing for rating agency, investor road show and investor discussions.• Advice on order period and marketing.	<ul style="list-style-type: none">• Advice on method of sale.• Advice on whether or not the client should approve/authorize the issuance.• Advice on referendum campaign.• Advice on overall financial controls, debt portfolio impacts, debt capacity, and analysis not specific to an issuance.• Preparation of financial feasibility analyses and budget planning.



What are the circumstances that allow an underwriter to provide advice to an issuer? (cont.)

2. **RFP Exemption.** A firm can provide advice in response to a request for proposals or qualifications ("RFP").
 - RFP must be conducted by the municipal entity or obligated person (or a registered MA acting on its behalf); identify a particular objective; be open for a reasonable period of time; involve a competitive process (sent to at least three reasonably competitive market participants or publicly disseminated by its posting on an official website).
 - Exemption also applies to "mini-RFPs" that are targeted to market participants that have previously been pre-screened or pre-qualified.



What are the circumstances that allow an underwriter to provide advice to an issuer? (cont.)

3. **Independent Registered Municipal Advisor (“IRMA”) Exemption.** An underwriter can provide advice with respect to a municipal securities issuance without being regarded as a municipal advisor if the client is otherwise represented by an independent registered municipal advisor with respect to the matters on which the firm intends to provide advice, including in a general capacity.
- The firm must receive a written representation from the client that it is represented by, and will rely on (or seek and consider) the advice of, an independent registered municipal advisor.
 - The written representation can be posted on the issuer’s official website and state that the issuer intends that market participants receive and use it for purposes of the IRMA exemption.
 - The firm must disclose in writing to the client (with a copy to the municipal advisor) that the firm is not a municipal advisor and is not subject to a fiduciary duty set forth in Section 15B(c)(1) of the Securities Exchange Act of 1934.



How does the Act impact underwriter relationships with Municipal Advisors?

- Correspondence with Municipal Advisor is subject to the same rules as if the correspondence was directed to a potential client.
- Cannot provide advice unless one of the three exemptions applies.
- The Municipal Advisor becomes the gatekeeper between the underwriter and the Municipality, limiting what ideas reach the client.
- An underwriter's correspondence with a Municipal Advisor is limited.



Underwriters have always been regulated so how is this different?

- The MA Rule requires the following of Municipal Advisors:
 - Registration of municipal advisors and municipal advisory professionals with the Securities Exchange Commission.
 - Underwriters are already registered with the SEC and must complete separate registration for MAs.
 - Regulatory examinations.
 - Underwriting professionals are already required to take examinations and continued education (e.g. Series 52 or Series 53).
 - Subject to MSRB Rules (fair dealing, political contributions, gifts, etc.)
 - Underwriters already subject to these rules.
 - Maintenance of books and record keeping.
 - Underwriters already subject to record keeping requirements and anonymous evaluations.
 - Establishment of a supervisory system designed to achieve compliance with the rule including creation of compliance policies/procedures, establishing a chief compliance officer and conducting annual reviews.
 - Underwriters already established compliance policies/procedures as a broker-dealer which were modified to accommodate the MA Rule.



Underwriters have been regulated so how is this different? (cont.)

- Create a further separation of roles for Municipal Advisors and Underwriters than existed under prior regulations.
 - Determine role prior to providing advice or information.
 - Done through (i) underwriting engagement (or pre-engagement) letter, (ii) financial advisor contract, (iii) RFP exemption or (iv) IRMA exemption.
 - Inclusion of important disclosures on all correspondence prior to engagement defining the role the firm is seeking.
 - If a firm provides advice when an exemption does not apply, the firm is regarded as a municipal advisor and prohibited from underwriting.
- Limitation on what and how information can be provided prior to engagement.
- Underwriters have always had a regulatory relationship with clients that requires them to treat them fairly and honestly.
 - This has not changed.

