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10 Years Later: Laws and Rules that Reshaped the Muni Market.

WASHINGTON – The financial crisis of 2007 and 2008 led to sweeping changes in the municipal securities market, many of which were prompted by new regulations and legislation.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in part to address issues that arose during the financial crisis, subjected non-dealer municipal advisors to a first-time federal regulatory regime and imposed on all MAs a fiduciary duty to put clients' interests first before their own. It expanded the definition of MAs and also set up a first-time regulatory regime for interest rate swaps and other derivatives.

Dodd-Frank expanded the Municipal Securities Rulemaking Board's mission and resources as well as reoriented its board away from the entities it regulates. The act made dealers rather than issuers responsible for funding the Governmental Standards Accounting Board and it led to the restructuring of the tender option bond market.

Auction rate securities froze, then virtually disappeared. Bank liquidity facilities became unaffordable for variable rate demand obligations, diminishing that market. As a result, the MSRB created transparency systems for ARS and VRDOs to provide investors with more information about these markets. Also, money market funds underwent major regulatory reforms.

The Securities and Exchange Commission began playing a stronger enforcement hand, as evidenced by its Municipalities Continuing Disclosure Cooperation initiative, best known as MCDC.

The American Recovery and Reinvestment Act, designed to help stimulate the economy, eased tax requirements for munis and created taxable Build America Bonds, at least for a while.

Some market participants think the financial crisis and the aftermath had a positive effect on the municipal securities market.

"It had a pretty significant impact on the municipal market," said Ernie Lanza, senior counsel at Clark Hill who was MSRB general counsel during that time. "But I think the market did ride it out better than people had expected," and it led to more transparency and behavioral changes such as an increased focus on suitability of products and compliance, he said.

Others, especially those at banks and broker-dealers, say it led to too many costly and burdensome regulations and restrictions that caused small and regional firms to either drop out of the market or consolidate.

"There were various aspects of Dodd-Frank that fundamentally changed how the municipal market operates and how dealers interact with their clients," said David Cohen, senior legal counsel at RBC Capital Markets who was executive director and regulatory compliance business manager at UBS Investment Bank in 2008 and SIFMA managing director and associate general counsel from June 2011 through September 2015.

“A lot of these new rules require expensive systems and the regulators also have a much higher expectation of what supervisory systems look like,” said Cohen.

“No one likes increased costs. The larger firms have a capacity to absorb it better …. Smaller firms closing results in less competition, which doesn’t necessarily benefit retail investors,” he said.

“The federal regulatory environment since the 2008 credit crisis has contributed to thousands of regional and small broker dealers merging, paring back lines of business or closing shop all together,” said Mike Nicholas, chief executive officer of Bond Dealers of America. “Since 2008, securities regulators have implemented the municipal advisor rule, a new best execution rule for municipal securities, and retail confirm disclosure rules for all of fixed income securities — to just name three — which have forced dealers to significantly ramp up their legal and compliance costs.”

Nicholas also said “the SEC essentially forced all municipal underwriters to self-report under MCDC, which imposed enormous costs on those dealers” and pointed to other rules.

“Cumulatively, these regulatory changes have had dramatically negative impacts on the US fixed income business impacting not only the dealers but their clients and overall market liquidity — which will most certainly be felt at the next market downturn. While BDA members stepped up to provide much needed liquidity during the darkest hours of the credit crisis, the reward since then has been an avalanche of regulation simply resulting in a consolidation of power among a handful of firms and thousands fewer firms to serve Main Street clients coast to coast.”

An MSRB report published on June 19 said that the number of registered dealers has fallen by almost 32% over the past nine years to 1,346 in 2017 from 1,967 in 2009.

AUCTION RATE SECURITIES

Auction rate securities, which were first developed in 1984 and had grown into a $330 billion market of which muni ARS were a major part, were one of the early casualties of the financial crisis.

Downgrades of muni bond insurers scared customers away from investing in ARS, long-term securities with short-term interest rates reset periodically through auctions run by dealers. The ARS market froze in mid-February 2008 after banks and dealers, grappling with subprime mortgages and the credit crisis, stopped propping up ARS auctions with their own capital. The largest ARS market participants at the time were Citigroup and UBS, according to the Securities and Exchange Commission.

In a report issued in December 2017, SIFMA found that outstanding ARS were $14.3 billion as of that month, compared to $95.7 billion in January 2009.

Variable rate demand obligations also ran into trouble after banks stopped providing affordable letters of credit, standby bond purchase agreements and other liquidity facilities.

The SIFMA report showed that outstanding VRDOs were $142.4 billion in June 2018, compared to almost $421 billion in July 2009.

These developments led the MSRB to create transparency programs for ARS and VRDO, under which it collects information about these securities from broker-dealers and makes it public for free through its Short-Term Obligation Rate Transparency (SHORT) System over its EMMA website.

The SEC and some state attorneys general investigated ARS after that market froze. They took enforcement action against banks and broker-dealers that underwrote offerings or managed the auctions for misrepresenting to investors that ARS were safe, highly liquid investments equivalent to cash or money market funds. They forced these firms to buy back billions of dollars of ARS, especially from retail investors.

MONEY MARKET FUNDS

On Sept. 16, 2008 the Reserve Primary Fund, a large money market fund that had a lot of exposure to Lehman corporate debt securities when Lehman fell into bankruptcy, “broke the buck,” when its net asset value fell below $1 per share. This led to a run on institutional prime MMFs.

Treasury Department officials scrambled to put together a program to stem the outflows from MMFs, but initially only focused on corporate debt. Muni market participants warned Treasury officials that if they didn’t include munis, investors would shift from muni to corporate MMFs. On Sept. 19, Treasury announced the creation of a program to temporarily guarantee muni and corporate MMF account balances.

After Mary Schapiro became chair of the Securities and Exchange Commission in January 2009, she made it a priority to adopt MMF reforms that would prevent or minimize the possibility of such runs in the future, which would threaten the day-to-day functioning of the financial system. The changes the SEC made to its Rule 2a-7 on money market funds through 2016 caused significant changes in the MMF industry.

Under these rule changes, only retail and government MMFs can have stable net asset values (NAVs) of $1 per share. Because of the fears that institutional investors can pull out of MMFs quickly, those investors can only invest in either MMFs with floating rate NAVs, where the per-share value fluctuates according to the current price of the securities, or MMFs of government or government-sponsored securities.

The rule changes also imposed fees and gates to discourage redemptions. They required increased diversification in both issuers and letter of credit providers of MMF securities. They also increased transparency for MMFs, including added disclosures of daily and weekly liquid asset levels and disclosures of material events such as portfolio security defaults.

The SEC also adopted rule changes to remove all references to credit ratings in Rule 2a-7, which had been used to determine if securities were eligible for MMFs. Lawmakers and regulators became skeptical of ratings because the rating agencies failed to adjust ratings downward to reflect troubled securities and financial institutions leading up to the financial crisis. Removal of ratings from 2a-7 meant MMF portfolio managers had to rely even more on their analyses of the creditworthiness of the securities in their portfolios.

BUILD AMERICA BONDS

In an effort to provide stimulus to the U.S. economy, President Barack Obama pushed for, and signed into law the ARRA on Feb. 17, 2009.

The act temporarily eased a number of tax law restrictions for munis and created Build America Bonds, a ground-breaking new municipal taxable product that created a stir in the muni market. Administration officials hoped BABs would expand demand for municipal securities and give issuers access to the market during a time of stress. In lieu of an issuer’s providing tax-free interest to bondholders, Treasury would provide subsidy payments to BAB issuers equal to 35% of their interest costs.

Muni issuers were at first suspicious that BABs were a ploy to get rid of tax-exempt bonds. But BABs took hold and more than $180 billion of them were issued in 2009 and 2010, the two years during which ARRA was effective.

The Hiring Incentives to Restore Employment (HIRE) Act, enacted on March 18, 2010 to provide incentives to businesses to hire unemployed, allowed most types of tax credit bonds to also temporarily be issued as direct-pay bonds, similar to BABs, but at different subsidy levels.

Republicans criticized BABs, which they viewed as a Democratic Party policy, for having too rich of a federal subsidy, creating huge profits for underwriters, and causing issuers with a lot of debt to issue even more.

Muni issuers, who had been repeatedly promised the federal government would never back away from agreement to make subsidy payments, became disillusioned about BABs and other direct-pay bonds when sequestration cut into those payments in 2012.

DODD-FRANK

The Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted on July 21, 2010 to address some of the causes and problems stemming from the financial crisis and it even went beyond that. The act was responsible for extensive changes in the municipal market.

Dodd-Frank brought non-dealer, non-bank municipal advisors under a federal regulatory regime for the first time and subjected all MAs, including those at banks and dealers, to a fiduciary duty under which they had to put clients' interests first before their own. It also subjected them to new exams and professional standards.

Basically, dealers and non-dealers became subject to the same Securities and Exchange Commission and MRSB MA rules.

The legislation and the SEC's MA registration rule included a broad definition of municipal advisor as anyone or entity that provides advice to, or on behalf of, a municipal issuer or borrower with respect to financial products or the issuance of munis. It also picked up anyone who undertakes a solicitation on behalf of an issuer. In addition, the MA definition includes financial advisors, guaranteed investment contract brokers, solicitors, finders, third party marketers and placement agents, as well as certain swap advisers.

Dodd-Frank also set up a regulatory regime for swaps, with most muni interest rate swaps falling under the purview of the Commodity Futures Trading Commission.

The act expanded the MSRB's mission to protect state and local government issuers as well as investors. It authorized the MSRB to assist the SEC and Financial Industry Regulatory Authority with their exams and enforcement actions and permitted the board to obtain half the penalties they collected for muni rule violations. The MSRB writes muni rules, while the SEC and FINRA enforce them.

The act also mandated that the MSRB have a majority of public members on its board. Prior to the act, the self-regulator had a board of 15 members — five from broker-dealers, five from banks and five from the public. After Dodd-Frank was enacted, the board grew to 21 members — 11 from the public and 10 from regulated entities, including municipal advisory firms as well as banks and broker-dealers.

"There are different voices and views around the table and that impacted the nuances of the rules," said Cohen.

TENDER OPTION BONDS

Dodd-Frank also led to the complete restructuring of tender option bond programs because of its so-called Volcker Rule, which prohibited banks from conducting certain investment activities with their own accounts and limiting their dealings with hedge funds and private equity funds, called "covered funds."

In a traditional TOB program, the "sponsor" will deposit a fixed-rate bond or note into a trust, which will then issue two new certificates — a floating rate certificate sold to a money market fund and a residual certificate which may be sold to a mutual fund or closed-end fund or held by a bank. The floating rate certificate will have a tender option, supported by a liquidity facility to cover the purchase price of the tender receipts not remarketed. That shortens the maturity of the bond or note so it that it becomes eligible for purchase by a tax-exempt money market fund.

But the Volcker Rule prevented banks and their affiliates from sponsoring a TOB program, owning a residual certificate issued by a TOB trust, or providing credit enhancement, liquidity, or remarketing services to these programs.

"Tender option bond programs are a big consumer of municipal bonds and everyone had to redo their programs," said Cohen.

HQLA

More traditional munis took a hit when bank regulators, as a result of the financial crisis, adopted liquidity coverage ratio rules that required banks with at least $250 billion of total assets or consolidated on-balance-sheet foreign exposures of at least $10 billion to have a high enough liquidity coverage ratio — the amount of high-quality liquid assets (HQLA) to total net cash outflows — to deal with periods of financial stress.

The rules did not count any munis as HQLA because bank regulators thought they were illiquid. The stance drew loud protests from muni market groups that claimed the rules would dampen demand for munis by banks. After a long debate, in May of this year Congress passed a bill with a provision directing investment-grade munis to be designated as Level 2B under the bank liquidity rules, the same level as for mortgage-backed securities.

But the tax law changes enacted last December and the drastic lowering of the corporate rate to 21% has already dampened bank demand for munis. Rising interest rates will compound that because as a bank's cost of funding goes up, so will the tax penalty associated with holding munis.

The Bond Buyer

By Lynn Hume

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