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[Gallagher's 'Blood Oath' to Keep Focus on Munis.]

Securities and Exchange Commission member Daniel Gallagher has sworn to take up the cause of municipal market reform at the SEC, accepting the baton from Elisse Walter, who recently left the commission.

Many of the recommendations included in the commission's comprehensive 2012 report on the municipal market remain unimplemented, and muni issues have been slow to gain traction with federal policymakers and lawmakers. But the Republican commissioner, who took office in November 2011, said he is ready to push for some of those recommendations, particularly those on price transparency.

"I can tell you that I'll be pushing for us to continue to focus on these issues, especially with my former colleague Elisse Walter leaving," Gallagher said. "She was a real driving force for all this. We have a sort of blood oath between the two of us. I'll keep the flame lit here and make sure we continue to focus on these issues."

In fact, Gallagher would like to see more focus on fixed-income issues generally at the SEC.

"If I had my way, if I was king for a day, we would have the whole associate director group on fixed-income and trading and markets. We'd have 50 people."

The SEC's agenda is the prerogative of chairman Mary Jo White, who assumed leadership of the commission in April. Gallagher said that while he has no direct control over the SEC's schedule, he and other commissioners can and will weigh in on issues of special importance to them. Gallagher pointed out that while White has been getting acclimated to her role, former Senate staffers Kara Stein and Michael Piwowar also became new commissioners last month, meaning that they, too, have a lot of catching up to do.

"I know that chair White is getting up to speed on everything about the agency and that she takes fixed-income issues generally very seriously," said Gallagher. "I will be pushing hard to make sure fixed-income issues generally, munis specifically, are at the forefront. I think she knows, obviously, that we need our muni advisor rule out."

The Dodd-Frank Act mandated SEC oversight and Municipal Securities Rulemaking Board regulation of non-dealer municipal advisors in 2010, but implementation has been hampered by the SEC's failure to define the term. The SEC's initial definition of an MA, included in proposed registration rules, generated intense resistance from lawmakers and market participants, who said it cast too wide a net, covering individuals appointed to governmental boards and professionals already regulated.

Reps. Steve Stivers, R-Ohio, and Gwen Moore, D-Wisc., have sponsored legislation to define MAs more narrowly. The bill would apply to individuals engaged for compensation by an issuer or borrower to provide advice on muni issuances or muni financial products. It contains exceptions for dealers seeking to be underwriters or placement or remarketing agents and those providing related advice, as well as bankers, swap dealers and governmental board members.

Gallagher said the commission would release its definition soon, and blamed the extensive delay on mandatory time lines imposed by Dodd-Frank.

“The [initial] proposal was really bad, to put it bluntly,” he said. “It was way too expansive, it generated way too much comment and push back, it generated way too much interest on [Capitol] Hill. And so it just became controversial when it shouldn’t have. And it doesn’t mean the staff didn’t do a good job. It doesn’t mean that the staff isn’t excellent. It just means that a lot of these Dodd-Frank rules have very arbitrary deadlines where the agency rushed to get the proposals out in a vain attempt to actually look like we were going to hit those deadlines. The proposals weren’t as good as SEC proposals usually are.”

Muni Report

“I’m focusing on the final product and hoping to get that out, and hoping it is as good as it seems like it is,” he said.

Gallagher signed the muni market report and is generally supportive of its goals, particularly the recommendations for the SEC or MSRB to take administrative action to improve price transparency.

He is not sure about the recommendations for legislative action to allow the SEC to dictate the form and content of issuers’ muni disclosures.

“I worry, obviously,” Gallagher said. “I don’t think we have the authority. I know the report raises that issue. It says we’re not denied the authority. I think we’d have to be pretty creative to go after that.

I’ve got to tell you I personally think that if that’s something we’re going to move to, that’s something that Congress should take up.”

Any such legislation would likely be very controversial. Gallagher said a “more realistic” would be to push issuers and other market participants to voluntarily improve their disclosure practices.

Asked about the SEC’s recommendation that Congress give it authority to require issuers to use generally accepted accounting principles set forth by the General Accounting Standards Board, Gallagher said he would prefer urging issuers to disclose whether they are using the GASB standards and, if not, what kind of accounting systems they are using.

Gallagher said he has spoken to White about striking a balance between legislating that has to be done by Congress and rulemaking that the SEC can do itself.

“One of the things I’m impressing with chair White, and I know she understands is very important, we need to have a healthy mix of mandated rulemakings from Congress but also voluntary things,” he said.

He said he is very much concerned about state and local pension liabilities and whether governments are accurately disclosing their pension problems. But he noted the SEC has brought enforcement cases in this area and said he expects that focus to continue from an enforcement standpoint.

Financial Crisis

But the SEC's new muni-market flag bearer was cautious about wading back into the water as a commissioner, having endured what he characterized as an "intensely traumatic" time as deputy director at the commission's trading and markets division during the 2008 financial crisis, when he spent a lot of time on the floor of Lehman Brothers, a firm that collapsed as a result of the crisis.

The Philadelphia native first joined the SEC in January 2006, serving as counsel to Commissioner Paul Atkins and later to SEC chairman Christopher Cox.

"All this gray hair came in 2008. I did my time," he said. "It was an awful period. Professionally, personally, it was just one of the worst periods ever."

Gallagher left the SEC in January 2010 to become a partner in the Washington office of WilmerHale, where he was making more than $1 million per year. He said his work at the firm was a good fit for him and that private practice always provides some independence.

He had seen Cox and former SEC chair Mary Schapiro unfairly maligned by Congress, the press, and the public in the aftermath of the financial crisis and the Bernard Madoff ponzi scheme scandal. "We were attacked. This agency was attacked during the crisis. Unfairly. Some things fairly, but mostly unfairly," he said.

Speaking of Cox, who was portrayed as uninterested and ineffectual during the financial crisis in 2008, Gallagher said he was dismayed at what he perceived to be a highly inaccurate portrayal of the man whom he worked closely with. "He's brilliant. High, high IQ, high functioning man. This notion that he's some buffoon I think is insanely unfair. That's the peril."

"Who wants to be sitting here when this stuff blows up?" he asked, noting that at the SEC, commissioners and officials are closely scrutinized by Congress, the press, the public, the industry, other market participants and investors.

But when a Republican seat on the commission needed filling, Gallagher was seen as the perfect candidate, one who would be well-equipped to know which Dodd-Frank rules were needed and which were overkill, given his role in the center of the maelstrom that led to the new law.

"The Senate Republicans were looking for someone who could deal with the Dodd-Frank implementation. A lawyer who could handle the rules, and somebody who knew the building," he said. "To wade back into it was not an easy decision, but at the same time, it was an honor to be asked."

From the commissioner's chair Gallagher has been one of few appointees to speak publicly about muni bond issues. He is a critic of much of Dodd-Frank, an advocate for tough enforcement against municipalities and muni officials who commit fraud, and a proponent of more investor education focused on the fixed-income markets.

Dodd Frank and SROs

Gallagher said that while he is glad Dodd-Frank mandated the reviving of an independent Office of Municipal Securities that reports directly to the SEC chairman, he thinks the mandates in that and other legislation risk harming the market and warping the role of self-regulatory organizations like the Municipal Securities Rulemaking Board.

"I've been very public with my dislike of Dodd-Frank," Gallagher said. "I'm just hoping that we're not inserting too many frictions and costs into the space."

Gallagher said Dodd-Frank's requirement that the MSRB have a majority public board is an example of how SROs have been transformed into arms of the federal government, rather than the self-regulators they were intended to be.

"I don't like dictating things like that," he said. "I think the SROs have gotten so far away from being truly SROs, that we have to be very mindful of that here. That they're just arms of the federal government, or they're so strictly controlled by the federal government through these prescriptive requirements like the majority-public [board], that they're getting too far away from what they're supposed to be. They're supposed to be groups of the regulated."

Instead, the SEC should provide oversight and step in if the SROs are not fulfilling their missions. Gallagher said.

"If they're not doing a good job, if they don't have vibrant rules or they're not enforcing them, that's what we're there for," he said. "But they're not supposed to be arms of the federal government."

The commissioner said he is on board with the SEC's initiative to crack down on muni violators of federal securities laws, a philosophy that has resulted in a string of enforcement cases throughout 2013 and that many market participants believe will continue under the leadership of White, who was known as a tough prosecutor of financial crimes.

Gallagher fired one of the opening salvos on this issues in a May 10 speech at the 45th Annual Rocky Mountain Securities Conference in Denver, Colo.In that speech, he called for individuals to be held accountable when they violate securities laws or rules. He cited the SEC's case against Harrisburg, Pa., which did not single out the alleged misconduct of any individual city officials or employees. Gallagher said he sympathizes with public officials but does not believe the commission should shy from playing hardball when violations occur.

"Municipalities don't commit frauds, people do," he told The Bond Buyer. "I think traditionally there has been a reluctance to go after fellow public servants in this space. Folks who truly are, sometimes might just be, overwhelmed. You want to always encourage public service involvement. At the same time, they're accessing the capital markets. Just the way a corporate issuer accesses the capital markets. They're selling to investors."

Gallagher added that the extremely high rate of retail investor participation in the municipal market means SEC oversight might be even more key, because other markets do not have such high participation rates of less sophisticated investors who require more protection.

"In many ways, what they're selling is much more dear to us here and our mission," he said.

Gallagher has spoken out repeatedly about a lack of investor knowledge in the fixed-income markets, which includes municipal as well as corporate bonds. He created a stir in April at an SEC roundtable on fixed-income securities when he warned of a possible muni bond "Armageddon" that could follow when the Federal Reserve Board stops holding interest rates at an artificially low level. He said later that he did not intend for the remarks to be as dramatic as they became, but he remains very concerned by studies that show a very low percentage of bond investors really understand the ins and outs of the financial products they are purchasing. However, his remarks turned out to be "the best free investor education that the agency could have ever had," he said.

Investors "have no clue what it means when interest rates go up," Gallagher said. "Literally no clue. More than half, they couldn't tell you the simple impact of an interest rate rise on their fixed income investment. That's horrifying. It really is. It blows my mind. It really scares me."

If investors simply held their bonds, the damage would be minimal and they would at least not lose principal, he added.

"Unfortunately what you'll see is, especially with some more unscrupulous registered representatives and financial advisors, folks are selling their muni bonds prior to maturity. And they're getting killed. They're getting scalped on the fees, and they have no concept how that plays out to their overall investment. Every bit of their tax advantage that they experienced while they held it is out the window with the fees that they pay coming in and certainly going out. Folks don't get that. There's a real lack on the investor education side there. It's something that really worries me."

Like Walter, Gallagher has emerged as a force pushing for more transparency in the muni market. He said the SEC should encourage the use of alternative trading systems, but that he would oppose mandating it. He believes the muni market should have its own best execution rule, and said he does not understand the resistance of broker-dealers to using the term "best execution."

The Securities Industry and Financial Markets Association has floated an "execution with diligence" rule, but Gallagher said the rule should be called "best execution" and might be better written by the Financial Industry Regulatory Authority, which already has such a rule for corporate debt.

"We all know what it is, at a very general level. And if you want to spend more time, I think FINRA would be better suited than us right now at developing a really good best ex rule in the space," he said. "I don't understand the resistance. It should be embraced."

Money Market Funds

Gallagher finds himself a bit at odds with state and local groups over the issue of money market fund reform proposals the SEC released in June. One of those proposals would require most money market funds, excluding government funds and "retail" funds that restrict redemptions to $1 million per day, to use a "floating" net asset value rather than the current fixed $1 per share rate.

The proposals, which also include redemption fees and gates, are designed to prevent panic-driven runs on MMFs, similar to the ones that occurred in 2008 during the financial crisis after. Gallagher has always supported floating the NAV, but voted against an earlier reform proposal because it contained a so-called "capital buffer" rule requiring funds to keep a certain amount of capital in reserve.

State and local officials and groups have said the floating NAV would damage the usefulness of MMFs as an investment vehicle by reducing their liquidity. Issuers often use money funds to meet short-term cash needs and have also expressed concerns that switching to a floating NAV would require costly overhauls of their financing systems. Gallagher said he and other commissioners certainly remain open-minded to comments, but that he thinks the revised proposals focus on prime funds and give the muni issuers alternatives to floating rate NAV.

"In a worst-case scenario, if given their state law or other contractual arrangements they can't use a floating NAV, they need a constant NAV, they'll have the government funds to go to," he said. "So then you ask yourself the question: 'Do I want my state treasurer seeking yield in prime institutional funds when there's a government fund available? Is that the best way to use taxpayer dollars in the state? Is that how a fiduciary should be functioning?' Could be yes, seeking out extra yield, but if what we've heard and what we've studied about the risks inherent in prime institutional funds are real, then you really have to ask yourself the question: 'Should that be a place where you're putting taxpayer dollars?'"

One concern that nags him is the lack of resources for fixed-income and muni securities.. Recalling his stressful days following the Lehman Brothers bankruptcy in 2008, Gallagher said the lack of attention paid to these markets shocked him.

“People say, ‘Oh, what kept you up at night? Was it Lehman or the auto industry?’ It was the muni markets. Erik Sirri, who was the division director at the time, he and I were horrified that we had [only] two full-time employees [on munis],” he said referring to then-muni chief Martha Haines and Mary Simpkins “We no longer had a real office of municipal securities. We had two full-time, very capable employees, but two, for a $3.7 trillion market?”

At that time, the SEC had reached multi-million dollar settlements with a number of firms over auction rate securities, that not only required them to pay penalties, but also mandated them to buy back at par the ARS they sold to retail investors. Sirri and Gallagher were afraid the crisis would limit the firms’ abilities to carry out those agreements.

In addition, when the Reserve Primary Fund broke the buck in September 2008 and led investors to withdraw $310 billion from prime money market funds, SEC officials started worrying about the potential for withdrawals from muni money market funds — a concern that led the Obama administration to set up a temporary federal guarantee program.

Gallagher said if he had his way, he’d have dozens of people tackling fixed-income issues on a daily basis.

“We’re still so, so far away from where we need to be. We have policy issues to address, many of which are in the muni report. Almost all of which came up in the fixed-income roundtable. We have internal resource issues.”

He said he doesn’t expect Congress will give the SEC funds for this. “We have to do it ourselves,” he added. “I hope we will.”

The fixed income roundtable held earlier this year was one of Gallagher’s major requests of then-chairman Walter when he first became a commissioner, he said, adding he was glad to see the enthusiasm by both participants and commissioners. The simple act of talking about fixed income markets might seem basic, but represents progress in focusing a bit more on a part of the market that is not stocks, he said.

“It’s one of those things, where Congress beats you up about the equities markets, where the media beats you up about the equities markets. That’s what you resource,” he said. “That’s what you pay attention to because you know you’re going to get called out on it. An it’s called the Securities and Exchange Commission, right? We focus on exchanges, and there are no exchanges on the fixed-income side. It’s institutional behavior and we need to break it. We need to resource it, we need to get expert, and we need for investors to have a hell of a lot more information [on fixed-income].”

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