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Outlook 2014: Municipal Advisor Regulation to Dominate 2014.

Municipal advisor regulations are likely to be the focus of intense debate in 2014, as the Municipal Securities Rulemaking Board labors to release rules and broker-dealer groups continue to push for interpretations favorable to underwriters.

Dealer groups, non-dealer financial advisors, securities lawyers, issuer groups, and regulators all expect the implementation of MA rules to take center stage in the coming year. They don't anticipate much muni securities legislation in Congress.

The Securities and Exchange Commission released its MA definition in registration rules in September, finally fulfilling a mandate handed down by the Dodd-Frank Act in 2010. But even with the SEC's work substantially complete, 2014 could be the "year of the municipal advisor" as various groups jockey for position to lobby regulators and rally public opinion to their sides.

MSRB chairman Dan Heimowitz said the board will give priority to MA rulemaking during the year, his last with the self-regulatory organization.

"It's going to be the focus of a big part of our time in 2014," Heimowitz said in a recent interview.

An initial milestone that could come up in the first quarter of 2014 is the MSRB's release of a fiduciary duty rule, the cornerstone of the Dodd Frank mandate. The law places this duty on all firms or individuals giving particularized muni bond or derivatives advice to a municipal entity, meaning that municipal advisors must put the interest of issuers and other municipal entity clients ahead of their own.

Many MSRB municipal advisor rules were written two years ago when the SEC released a draft rule that it was forced to revise amid industry criticism that the language was too broad. Heimowitz and MSRB executive director Lynnette Kelly have said that the previously developed rules create a good base for the development of updated ones, including for the fiduciary duty requirement.

"We have a substantial amount of the board work done toward getting a draft out," Heimowitz said.

Once that rule is out and is approved by the SEC, the board could turn to work on other rules governing other MA conduct, such as supervisory requirements and limits on gifts, gratuities, and political contributions, Heimowitz said. The professional qualifications exam for MAs is something he highlighted as being much helped by the work of the MSRB staff. A rule dictating that is unlikely to be out this year, though "we hope to make a substantial amount of progress," he said.

Susan Collet, senior vice president of government relations at the Bond Dealers of America, agreed that the dialogue about MA regulation will now shift heavily to the MSRB, but said the SEC might still feel the need to chime in if it feels further interpretations or guidance are necessary.

Almost immediately after the SEC unanimously approved its MA definition, dealer groups and non-

dealer FAs began sniping back and forth over its workability. Dealers have taken the position that the rule will restrict their abilities to offer certain types of advice to issuers at the risk of being unable to do underwriting business with that issuer, while non-dealer FAs maintain that the rule contains enough exemptions to prevent necessary communication between issuers and underwriters from being impeded.

Continued disagreement about what the rule, which takes effect on Jan. 13, does or does not allow is likely to prompt more guidance from the SEC.

"It may not be the last we hear from them," Collet said.

Collet added that she didn't expect quick action from the MSRB, but that dealer firms will be putting together compliance regimes in the opening weeks of 2014.

Leslie Norwood, associate general counsel and co-head of municipal securities at the Securities Industry and Financial Markets Association, said the dialogue about the rule is likely to continue as firms begin to implement the SEC rule, especially between the industry and the MSRB. Heimowitz has said the board plans to provide for public comment on all its MA rulemaking, and may utilize an expanded 60-day comment period on some rules.

"We feel this rule will take up a lot of the year," Norwood said of the MA regulations. "The MSRB has a lot of work to do."

Norwood said that SIFMA will continue efforts aimed at making sure non-dealer advisors and dealer-affiliated advisors have to play by the same rules.

"It's going to be our goal to make sure there is a level playing field," she said. Dealers claim their advisory firms are subject to all of the MSRB rules while MAs are mostly waiting for the MSRB rules. They are already subject to a fiduciary duty and to the MSRB's Rule G-17 on fair dealing.

Jeanine Rodgers Caruso, president of the National Association of Independent Public Finance Advisors, agreed that the SEC would probably have more to add to the conversation on MA regulation. Caruso said she expects dealer groups to look for changes to the SEC rule.

A draft letter circulated to SIFMA members earlier this year indicated that the group would try to put pressure on federal regulators and lawmakers to alter or reinterpret the rule. The group has not followed through with a public campaign but NAIPFA issued sent an "open letter" to SEC chair Mary Jo White saying they support the rule and do not think changes are needed.

"Broker-dealer groups will continue to push for legislative changes to the municipal advisor rules," Rodgers Caruso said.

She added that she doubts the MSRB would be able to get some of the key MA rules functioning until late in the year.

"Although the MSRB will likely release various rules, we don't anticipate that the more complex rules, such as fiduciary duty and fair dealing, will be in place before the third quarter of 2014," she said.

Robert Doty, president and proprietor of municipal bond consulting firm AGFS, said the MA rules will be a major story in 2014 as the industry adjusts to being regulated for the very first time.

"I really think it's going to be a major shock to the industry, and I think there will be a lot of fallout

from it," Doty said.

He added that the onset of the regulations will lead to a slow weeding out of MAs who are not qualified or competent. Though there are many good financial advisors providing MA services, Doty said, there are many others who leave much to be desired and there are not enough good ones to serve all the municipal clients who could benefit from non-dealer advice.

Those changes could start in 2014, but will probably take much longer, he said, adding, "I think it's going to take years."

As large as the MA rule looms in 2014, there are other potential regulatory events that muni market participants will be watching for. One is the implementation of the Volcker Rule, which received joint approval from the SEC and other federal agencies earlier this month. The final rule contained a ban on proprietary trading, but exempted municipal securities, after several industry groups submitted comments urging that all munis, and not just state and local general obligation bonds, be exempt from the rule. However, the rule doesn't exempt tender option bonds, causing dealers and other observers to warn that it will hurt the market in the coming year.

TOBs are securities issued by a special purpose trust into which bonds deposited. The trust issues floating rate securities, which are sold to money market funds, and inverse floating rate securities retained by the fund that sets up the trust.

SIFMA and other groups have told the SEC that TOB transactions are far more sound than risky private equity or hedge fund deals. Banks say the bar will hurt the market by reducing liquidity. SIFMA is exploring alternatives to TOB transactions, which is something Norwood's co-head of municipal securities Michael Decker said will be "a big focus" next year.

William Oliver, an industry liaison with the National Federation of Municipal Analysts, agreed that Volcker could pinch the market next year.

"That's clearly a potential negative," he said.

Collet said it is hard to know right now how the Volcker Rule will affect munis, but said it should become clear soon.

"The implications of the Volcker Rule will be more apparent next year," she said.

Another area of interest is the creation of a best execution standard, which Kelly has said could be proposed for public comment following the board's January meeting.

The MSRB previously requested comment on whether it should create a best-ex rule, which would require dealer firms to make an effort to execute transactions with prices as favorable as possible for their customers, as required in the corporate bond marketplace. SIFMA and BDA have argued that the illiquid and opaque nature of the muni market makes it unrealistic to expect corporate-style regulation to be efficient, but the MSRB did not embrace SIFMA's milder "execution with diligence" rule proposal. Norwood said SIFMA looks forward to working with the MSRB on that rule.

Collet said the best-ex proposal will come early next year and is likely to involve all the key market regulators. The SEC would have to approve the new rule, and the Financial Industry Regulatory Authority may be involved in the dialogue as the author of a very similar rule for corporate bonds.

"I would expect the MSRB to put something out on that, and the SEC will have a view on that I am sure, as well as FINRA," Collet said.

Few market participants expect much legislative activity, and one Congressional aide said the securities discussion on Capitol Hill has largely gone quiet in favor of tax issues. Collet said some committees might hold hearings about municipal default and bankruptcy issues as the Detroit saga continues to unfold.

“For securities, I think it will be a fairly quiet year,” Norwood said of the legislative outlook.

Issuers will also be awaiting the fate of money market mutual funds, for which the SEC has proposed reforms intended to curb the systemic risk. The SEC has proposed moving most MMFs to a floating net asset value from the current stable NAV of \$1 per share. It also has proposed funds have liquidity fees and gates to discourage redemptions.

The proposals are aimed at preventing runs on MMFs such as the one that occurred during the financial crisis in 2008 when the Reserve Primary Fund “broke the buck” and led investors to pull more than \$300 billion from prime money market funds.

Issuer officials have complained that forcing MMFs to adopt a floating NAV would limit the ability of municipalities to use MMFs as an investment vehicle. Other market participants, and even some lawmakers, have also said MMFs are huge holders of muni bonds and the changes could cause a ripple effect through the market. Dustin McDonald, director of the federal liaison center at the Government Finance Officers Association, which has many members who invest in MMF, said the GFOA will be working on this issue along with the MA rule.

Heimowitz and Kelly said that the MSRB will continue to expand its outreach programs in 2014. Beyond rulemaking, the MSRB is active in investor and issuer education. Heimowitz said the board will be holding outreach events in both Atlanta and Chicago this year. Kelly said the group will probably ramp up its new media efforts to evolve beyond solely printed materials.

“We are spending a lot of time on videos,” Kelly said. “That is really a new component of our education program.”

The board will also host seminars and webinars on different topics, the MSRB leaders said.

-Mike Cherney

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