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[Why's the SEC's New Municipal Advisor Rule So Confusing?]

What governments need to know about where they should go to seek financial advice.

When the federal government creates totally new regulations, it can generate a fair amount of confusion. That's what's happening with the definition for Municipal Advisors, a new category of financial advisors specifically tailored for municipalities.

The backstory to this regulation is a long one. The condensed version is that the 2008 financial crisis showed regulators that governments needed someone looking out for their interests in financial transactions with Wall Street – and only their interests.

Historically, it's common for those orchestrating the trransaction to also dish out advice and counsel to the municipality entering into the deal. The problem with this model is that while most underwriters or brokers are fair and reasonable, there are many who are not.

Among the more famous bad examples, Jefferson County, Ala., officials were wooed in 2008 into entering into a complicated interest rate swap deal. The deal was orchestrated by a J.P Morgan Chase banker who (along with some county officials) later pleaded guilty to corruption charges related to the deal. The swap plan ultimately backfired and led Jefferson County into bankruptcy in 2011.

Regulations in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, passed as a response to the recession, establilshed that municipalities would have their own advisors who were regulated. The act left it up to the Securities and Exchange Commission to actually define what a municipal advisor is and is not.

Fast forward to today, and it's becoming apparent that idea is easier said than done. After a long wait, the SEC this past fall issued its definition for who constitutes a municipal advisor. Essentially, a municipal advisor is a qualified financial professional (i.e., a banker or financial consultant) who counsels municipalities on financial deals like bond offerings. That person must be registered through the SEC as a municipal advisor and cannot have any other interest in the deal. The problem? Well, even with nearly 800 pages of explanation, there is still a lot of room for questions. (Originally slated for January, the SEC delayed implementation of this rule unil July.)

For one, notes federal securities lawyer Paul Maco, municipal advisors are a new class of advisors. But because governments have so often sought advice from other financial professionals, making them defacto municipal advisors, creating a new line in the sand can be confusing. "This is a new group of regulated people dropped into a regulated area with different categories among them," says Maco, an attorney with the internatinonal firm Bracewelll & Giuliani. "So [for example], there's naturally some overlap between investment advisors or between broker/dealers."

The rule seeks to eliminate that overlap with this key difference: municipal advisors have an explicit fiduciary responsibility to solely their government clients. In other words, they are looking out only for the government's interests and have no other connection to a deal. In the same way a prospective homeowner would want her own real estate agent and wouldn't want to use the seller's agent, municipalities now must get advice on a transaction from someone who won't benefit financially in any way from the deal.

The concept seems to make sense but in practice it's proving to be difficult; governments are accustomed to getting advice from those assisting them in a financial deal. Issuers that are used to calling up their banker and asking her opinion about a transaction must seek counsel elsewhere. That banker can communicate market trends, ideas and issues. But anything considered actionable is off the table. "There's a lot of misunderstanding about what a financial advisor does or what a broker-dealer does," says Susan Munson, founder of the Fixed Income Academy, an online school that seeks to educate buyers and sellers in the bond (fixed income) market. "How they get compensated – that's where their allegiances are," she said.

Munson, who was an account executive with Merrill Lynch's Institutional Advisory Division before founding the academy, added that brokers or financial service providers may only be selling investments their company wants them to focus on. While they may still offer up unbiased advice in that realm, their view is limited.

"It boils down to, if people [have] a fiduciary duty, they have to behave in a certain away," she said. "There's [now] a standard of care you have to put ahead of your own – you can't advise them of anything not in their best interests."

There are exceptions. One applies to the Request for Proposals process – professionals who are not a government's municipal advisor can offer up advice in a proposal response. Another exception: If a government already has an advisor in place for a transaction, and that is made clear in writing, underwriters and other professionals involved in that same transaction can also give advice. But here, there has been yet another snag – according to the rule, issuers in this situation must still "rely on" the advice from their municipal advisor.

"So people are now saying what does 'rely on' mean?" says Susan Gaffney, who served as the Government Finance Officers Association's Federal Liaison Center director for more than a decade. "Does it mean always use? Mostly use? Everybody's struggling with what does this all mean and does this change how I approach an issuer?"

The gray areas are getting much of the attention (and consternation) now from municipalities and financial professionals tasked with living in the confines of the new rule come this summer. But the goal of the rule – to create a bright line between what constitutes advice and what doesn't and who really should be providing that to the issuer – is one that ultimately has government's best interest at heart.

"There's going to be near-term pain over the understanding and getting this in place," says Matt Posner, an analyst for Municipal Market Advisors. "But it's for long-term good. We should have responsible advisors and we should be able to educate those advisors and make them better."

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