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Behind California's Effort Targeting Bond Measure 'Pay-t--Play'.

LOS ANGELES — California Treasurer John Chiang's efforts to combat "pay-to-play" activities among local bond issuers received mixed reviews from municipal bond industry participants.

Chiang announced policies July 27 designed to limit what he called questionable municipal bond industry bankrolling of local bond election campaigns.

He has asked all finance firms that wish to participate in the sale of state issued bonds to sign certificates by the end of August pledging to not engage in what Chiang describes as pay-to-play practices related to bond measure campaign funding.

Chiang's program asks that the 105 financial and law firms in the state's pools, made up of 13 advisory firms, 26 law firms, and 66 underwriters, take the pledge. But he has gone a step further by extending it to any financial firms that do state business, Schaefer said.

"There are any number of state agencies that want to hire bond counsel for non-transactional work, who look to the state's pool," said Tim Schaefer, California's deputy treasurer for public finance. "That is why we wanted to up the ante."

The idea is that "if you want to do business in Sacramento, we want you to take the pledge that you will not engage in this activity, because we think this activity is corrosive for California issuers," he said. "The idea is not to humiliate anyone, or put them in the penalty box, because we are not a regulator; it is to change this behavior that is bad for California taxpayers."

Chiang's efforts continue the work of former treasurer Bill Lockyer and former Los Angeles County Treasurer and Tax Collector Mark Saladino, who both criticized what they saw as a pay-to-play environment in the state's municipal bond market.

Lockyer announced in 2012 that the state would no longer work with financial firms that engaged in pay-to-play or that had been involved in the sale of what he considered to be egregious capital appreciation bond deals.

"We certainly salute and applaud what Lockyer did, but if we thought it was sufficient, we would not be taking it to the next level," Schaefer said. "We are not deeming Lockyer's efforts a failure, but we will just have to wait and see if we get a better effect – and I think we will get a better effect."

Municipal bond firms are already charging lower fees, said Adam Bauer, president and chief executive officer of Fieldman, Rolapp & Associates.

"We have already seen the costs come down when we negotiate the underwriters' discount," Bauer said. "That has come down from years' past."

Bauer said he did not know if previous efforts by Lockyer or enforcement efforts by the Municipal

Securities Rulemaking Board and U.S. Securities & Exchange Commission are responsible for the decline; or what part increasing competition among municipal finance firms has played.

Issuers are free to set their own standards and requirements above and beyond those set by the MSRB and other regulators, said Leslie Norwood, managing director and associate general counsel of the Securities Industry and Financial Markets Association. But SIFMA does advocate that such requirements are clear and effective to achieve their stated goals, she said.

Twelve of SIFMA's biggest dealer firms signed a letter in July 2013 asking the MSRB to adopt further restrictions on bond ballot contributions by broker-dealers, and each of those firms pledged a two-year moratorium on making any such contributions related to bonds they sought to underwrite.

Chiang's program is another step in the right direction, Bauer said, because firms that engage in such activities make it harder for ethical firms to compete.

"I think it is great they are doing something like this," Bauer said. "But the firms in the pool are not the firms I understand to be doing this type of thing."

The financial advisory firms engaged in "pay-to-play" bond measure activities do not have the resources to go after the state's business, Bauer said.

He believes the activities the treasurer is targeting are more prevalent in smaller districts that don't have the resources to pay for campaign services.

"The steps that Lockyer took set the tone and it is not now taking place in the areas in which I work, but I think it is good to formalize it so there is more pressure to conform by firms who operate outside of the norm," he said.

A Bond Buyer data review found a nearly perfect correlation between broker-dealer contributions to California school bond measure campaigns in 2010 and their underwriting of subsequent bond sales, and financial advisors have similarly been accused of using "pay-to-play" tactics.

Some underwriting firms in the state pool that used to provide free bond campaign services to school districts have discontinued the practice, Bauer said. He knows of one firm where the person who had that role split off from the company to form her own firm to avoid the conflict.

Another area where Chiang has expanded Lockyer's efforts is by including bond counsel in the mix.

Restrictions placed under Rule G-37 by the MSRB and the U.S. Securities & Exchange Commission do not apply to bond counsel, because those entities only regulate broker-dealers, said Lisa Greer Quateman, a partner with Polsinelli, one of the law firms in the state's pool.

"We personally do little school bond work, so we have happily executed the certification and are unaffected by it," Quateman said. "Polsinelli was very comfortable signing the certification."

Though school district general obligation bond referendums have been the focus of previous efforts, Schaefer said Chiang's efforts are aimed at all local bonds.

Quateman said some lawyers would actually like to have Rule G-37 apply to law firms. But she said there are others who are concerned about how such restrictions would impact their First Amendment rights to participate in the political process.

“I am very happy that I am able to participate in the political process and help worthy candidates get their messages out,” Quateman said. “I am glad I am free to do that. I think the MSRB was very careful in the way it shaped Rule G-37.”

Quateman also thinks the treasurer was careful in how he structured his certificate so that it only asks participants to certify that they will not make campaign contributions toward bond transactions on which they plan to bid.

But Benjamin Keane, a managing associate at law firm Dentons and a member of its ethics & disclosure team, thinks there may be reason for concern.

The treasurer’s certificate is more all-encompassing than MSRB and SEC restrictions, Keane said in an interview.

“While the addition of a few basic certifications statements may seem minor to the untrained eye, requiring affirmative statements such as these will also almost certainly heighten the compliance risk borne by the regulated community,” Keane wrote in a blog post he co-authored with Dentons partner Stefan Passantino. “After all, the “inadvertent non-compliance” defense is dramatically more difficult to assert, and a “false statement” indictment is dramatically more easy to obtain, when affirmative certifications are a compliance obligation.”

Firms that wish to be included in the state’s bond pool have to make an affirmative statement that neither the firm, or any officer, director, partner, co-partner, shareholder, owner, or employee will make any cash or in-kind service contribution.

That differs from MSRB and SEC regulations where the restrictions are directed at the companies or directors of the company, Keane said.

He will be watching to see if some of the larger companies in the pool are removed if a shareholder or employee violates this rule, he said.

“It doesn’t just include contributions to ballot measures, but to any campaign in the state,” Keane said. “It is harder for an underwriter in the pool to tell its employees that they cannot donate to any ballot measures in the state than to restrict them from any activities that involve bond campaign services.”

The treasurer’s office not only wants to impact the way financial firms operate in California, but hopes to set an example for the entire $3.7 trillion municipal bond industry.

“We are hoping this will bend the discussion similarly to what Lockyer’s efforts did,” Schaefer said. “It has already attracted more attention than what Lockyer did, because this one has more teeth to it.”

The treasurer’s office did not act capriciously, Schaefer said, adding that it has been meeting for a year to line up support. Supporters include the California Association of County Treasurers and Tax Collectors.

“You would be startled by the number of people at financial firms who reached out and said ‘Thank you for doing this,'” Schaefer said. “Now they feel like they won’t get undo pressure to do what the fringe players are doing.”

Schaefer said Lockyer laid the groundwork for Chiang’s efforts.

“It increased awareness of the phenomenon, because this situation we are trying to address lives in the shadows,” Schaefer said.

No contracts are signed outlining what occurs in pay-to-play arrangements.

“Pay-to-play cases even in white collar cases can be hard to prove, because they are often quid pro quo,” Keane said.

School districts or municipalities that later hire financial firms who donated to a bond measure campaigns or provide free campaign services don’t sign contracts agreeing to pay higher fees on the transaction.

California Attorney General Kamala Harris had an opinion earlier this year that school district officials could be subject to penalties if they hired someone who had contributed to a bond campaign, Keane said.

“But you run into a situation of how do you prove that quid pro quo is going on?” Keane said. “It is difficult to show unless there is smoking gun evidence.”

The Bond Buyer

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