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OUTLOOK: Markup Disclosure, MA Rules On Tap for 2017 Despite SEC Uncertainty.

WASHINGTON – In the regulatory and legislative arenas next year, dealers will have to grapple with how to set up compliance programs for markup disclosure rules while municipal advisors try to adjust to the many rules adopted in 2016 and issuers work to improve disclosure to stave off legislation.

Their actions will come against a backdrop of uncertainty with new leadership at the Securities and Exchange Commission and a more powerful Republican Congress focused on deregulation.

Much of the uncertainty stems from questions about who President-elect Donald Trump will name to chair the SEC. The commission has been working with only three of five commissioners for roughly a year and SEC chair Mary Jo White has said she will step down as President Obama leaves in January.

The individuals named to fill the vacated positions will control how much the SEC focuses on the municipal market as well as efforts to roll back the Dodd-Frank Act.

The amount of time it takes to fill the SEC positions will also affect regulatory actions in 2017, participants said.

"At this moment, we're barely a month after the election and the idea that everything is possible in 2017 is in obvious conflict with the amount of time" regulators and Congress will have, said John Vahey, managing director of federal policy for the Bond Dealers of America. "For the regulatory agencies to get in there and organize and adopt a new regulatory agenda there's obviously some natural constraints as to what is likely to happen in the next 12 months."

Officials in the SEC's Office of Municipal Securities declined to comment, citing the large number of unknowns at the commission.

Dave Sanchez, senior counsel with Norton Rose Fulbright in San Francisco and a former SEC muni official said that he does not see anything "big picture" like new rules happening at the SEC in 2017.

"But the kind of stuff like staff guidance and coordination with the Office of Municipal Securities and Division of Trading and Markets at the staff level, I think that can be accomplished for sure," Sanchez said.

He added that munis are not really partisan and that the "determinative factor" for whether there is action in the muni market is whether those who are appointed to fill the empty SEC slots have an interest in munis.

"That's the best test of whether you will see action," Sanchez said. The other question, he said, is whether the SEC's OMS staff will be able to get enough of the commissioners' attention to take certain steps such as producing guidance for muni rules.

Ernesto Lanza, senior counsel with Clark Hill here, said that despite the challenges the changeover and possible deregulation may present for rulemaking, there will be rules that will get through either because they need to or because they are not controversial.

However, he added that a regulatory slowdown could extend to self-regulatory organizations like the Municipal Securities Rulemaking Board.

“SROs are one step removed so there’s more of an ability to move forward,” Lanza said. “I’m not sure how much harder it is going to be at the SRO level, but I do think it will trickle down to an SRO basis.”

Colleen Woodell, chair of the MSRB, said the board stays apolitical and has worked with a number of different administrations and parties throughout its existence. She said she expects that the MSRB will work similarly with the new administration.

Lynnette Kelly, the MSRB’s executive director, echoed Woodell, saying the self-regulator’s mandate of protecting investors and issuers “is kind of mom-and-apple-pie so it’s hard to disagree with a lot of it.”

Market participants said that some of their uncertainty about the new year also rests with Congress. They pointed to one piece of legislation, the Financial CHOICE Act, as a potentially important bill for financial regulation.

Michael Decker, managing director and co-head of municipal securities for the Securities Industry and Financial Markets Association, said that if Congress decides to dedicate some energy to revisiting financial regulation, it may not enact the CHOICE Act, but the legislation “is an indication of where they might start.”

The bill, proposed by Rep. Jeb Hensarling, R-Texas, would, among other things, divert funding the MSRB gets from enforcement actions over its muni rules to the Treasury Department, move the Office of Municipal Securities back under the Division of Trading and Markets, and repeal the Volcker Rule, which prohibits banks from trading on a proprietary basis and restricts their investments in hedge funds and private equity.

It is a wide-ranging piece of legislation designed to roll back Dodd-Frank regulations and implement other changes that Republicans have been considering.

Hensarling, who chairs the House Financial Services Committee, was able to shepherd the bill through his committee but the measure did not move any further during the congressional session. The Texas lawmaker has since said he intends to review and improve on the bill before reintroducing it in the next congressional session. It is unclear whether the parts of the bill affecting munis will remain and it is also possible that he could add new sections with implications for the muni market.

Paul Maco, a partner with the law firm Bracewell here, said the bill shows a focus on controlling and winding back regulation to some degree, but that he believes most Dodd-Frank cutbacks would not directly impact the muni market.

Susan Gaffney, executive director of the National Association of Municipal Advisors, said the group wants to make sure that there are no changes to Dodd-Frank or the SEC’s MA Rule that would water down the fiduciary duty for all MAs. She added that NAMA would also like to see OMS kept independent as it believes the office has done well in its standalone capacity.

BDA hopes the bill will bring “reasonable regulatory relief” from Dodd-Frank as well as other improvements like requiring regulators to put more emphasis on cost-benefit analyses.

Muni market participants are also watching to see if there will be further movement on a proposed bill from Rep. Gwen Moore, D-Wis., that was introduced earlier this month. The bill would follow the SEC's 2012 Report on the Municipal Market in shifting municipal disclosure responsibilities to issuers and borrowers from underwriters. The SEC cannot currently directly regulate issuers' disclosures. It can only take enforcement action under federal securities antifraud laws and rules.

The Moore measure would give the SEC authority over the content and timing of muni issuers' bond-related disclosures as well as the accounting systems they use.

While many muni participants said the bill in its current form will not get traction, they noted that it sends a message to the industry, and specifically issuers, about the real possibility of such a shift. The idea follows in the wake of the SEC's Municipalities Continuing Disclosure Cooperation initiative, which showed continuing disclosure violations were widespread in the market.

Leo Karwejna, chief compliance officer with The PFM Group, said the proposed legislation is "a bit of a test balloon" but that he ultimately thinks "the drumbeat has continued to grow louder … on how to more directly regulate issuers themselves."

"I think people take that as a shot across the bow as what could happen," he added. "It's probably in everyone's collective best interest for [the disclosure] focus to continue."

Emily Brock, director of the Government Finance Officers Association's federal liaison center, said that the bill wasn't "a gigantic surprise and punch to the gut" because of the group's knowledge of the 2012 report recommendations. GFOA will continue to have comprehensive conversations about disclosure and will be "sure to mobilize if the threat does pop up," Brock said.

The SEC, despite the turnover, may also reasonably be expected to open up its Rule 15c2-12 on disclosure in the municipal market, some said.

Sanchez said that MCDC showed the difficulty that existing SEC staff guidance creates for issuers that are trying to keep a uniform continuing disclosure regime. Those issuers may be monitoring continuing disclosure agreements that span a 20 to 30-year period.

"The information provided [and] the way it is provided, just even the agreements themselves, are all going to change in minor ways," Sanchez said. "That makes it very hard to be in 100% compliance."

He added that he thinks the updated guidance "has a really strong chance of happening" and that "there's no reason not to do it."

"It's something the entire market is looking for the SEC to do," Sanchez said. "As a matter of good faith, the SEC should undertake to provide that kind of clarifying guidance."

Market participants, along with the MSRB, have also been urging the SEC to address the issue of bank loan disclosure in the market. Bank loans have become a more attractive debt vehicle for issuers in recent years, but analysts, rating agencies and others have expressed concern that the lack of disclosure of these loans has clouded issuers' finances. An issuer may have obligations that are hidden from the rating agencies and investors.

Many market participants would like the use of bank loans to be disclosed as material events under the SEC's Rule 15c2-12. Several market participants said the SEC may open the rule up next year to make that change.

Aside from the speculation about what a new administration and Congress can accomplish, there are several areas of regulation that participants believe they will be working with in 2017.

The MSRB plans to continue with its steps toward rulemaking related to syndicate practices and pre-trade price transparency, both of which Woodell and Kelly have said will be complex, multi-year initiatives.

The self-regulator will also focus on modifying its existing prohibitions on trading below a bond's stated minimum denomination. Other plans include work on: continuing education requirements for municipal advisors; an advertising rule that could affect both MAs and dealers; development of an exam for MA principals; guidance for solicitor MAs; and further improvements to its EMMA website.

The MSRB will add a new issue calendar to EMMA starting in January and Woodell said there is a possibility the system will include third-party yield curves by the end of 2017.

Bill Oliver, industry and media liaison for the National Federation of Municipal Analysts, said EMMA improvements will continue to be a focus for the NFMA next year.

"I think [EMMA] has exceeded its original goal of being a repository but it's been so successful that it has pointed out the need to go to the next level and become a more sophisticated database with better technology," he said.

One item that stands the most chance to take up participants' attention in the new year is the implementation of the MSRB's recently approved rule changes requiring dealers to disclose their markups and markdowns on certain transactions.

Leslie Norwood, managing director and co-head of munis for SIFMA, compared dealer efforts to come into compliance with the markup rule by its effective date on May 14, 2018 as a "full court press."

Vahey said the rule is going to require "a very big build from a tech, personnel, operational, and compliance standpoint for all dealers."

The markup requirements are the culmination of a years-long process that came to fruition this year through changes to MSRB Rules G-15 on confirmation and G-30 on prices and commissions. The rule changes mandate that a dealer, which buys or sells munis for or from its own account to a retail customer and engages in one or more offsetting transactions on the same trading day in the same security in an amount that in aggregate equals or exceeds the size of the customer trade, discloses its markups and markdowns in the confirmation it sends the customer. The amendments also establish a waterfall of factors for determining prevailing market price, which dealers are to use to calculate their compensation.

Dealers have expressed concern that it will be difficult and costly to automate compliance with the waterfall of factors.

Lanza agreed that there will be a lot of work in 2017 to get the markup disclosure rule implemented correctly and added the requirements exhibit a concern he has with rulemaking while reliance on technology is expanding. He said the rule is "fundamentally backward-looking" in that it is based in the tradition of notification by paper.

"I just get worried that it is going to be a costly effort that [dealers] are going to have to rebuild five years from now anyway because the entire underlying structure of how things are done is going to change," he said.

Municipal advisors in 2017 will continue their adjustments to the still relatively new regulatory structure that applies to them while asking the regulators for additional guidance, according to MAs.

“Continued implementation of G-42 will be one of, if not the biggest, thing for the next year,” Karwejna said. “When you think about G-42, there’s a lot of room for interpretation and inconsistency.”

MSRB Rule G-42 on core duties of MAs says municipal advisors owe a fiduciary “duty of loyalty” to their municipal issuer clients and are required “without limitation … to deal honestly and with the upmost good faith with a municipal entity and act in the client’s best interests without regard to the financial or other interests of the municipal advisor.”

The rule also contains a “duty of care” for all clients that requires MAs to: exercise due care in their work; be qualified to provide advisor services; make a “reasonable inquiry” into the facts relevant to a client’s request before deciding whether to proceed; and undertake a “reasonable investigation” to determine their advice is not based on bad information.

Karwejna said that he and other MAs are hoping for more specific guidance on G-42 and other rules, as advisors are often relying on their own rule interpretations to get through examinations by the SEC’s Office of Inspections, Compliance, and Examinations (OCIE).

“As compliance officers, we can interpret and say what we believe the rule says and write policies based on that, but really the more guidance we can get from the regulators themselves, the better the consistency at which we all can deliver the end result,” Karwejna said. “The last thing you want to do is be sitting at a table with an examiner saying, ‘That’s not really how we think about it.'”

Karwejna and Gaffney both said it would be helpful if the OCIE examiners put an alert or other document together explaining their findings in their first rounds of examinations.

The end of the year-long window in which already practicing MAs can take the Series 50 professional qualification exam will also be a major development for MA regulation in 2017, Gaffney and Karwejna said. The exam program, which gives MAs a year from September 2016 to take and pass the test, is expected to lead to some decrease in the amount of advisors practicing in the muni market, but the exact change that it could help precipitate remains to be seen.

One other development MAs may see is some regulator guidance or indication of how they should handle work with issuers that are pursuing bank loans or private placements. There has been concern in the past that an MA’s work with such products could place it in situations where it is actually engaging in broker-dealer activities without being registered to do so.

Sanchez said he thinks the SEC will need to give additional guidance on the whole exemption from broker-dealer registration for MAs. He said it could be done through a no-action letter or some other staff-level guidance, either of which would be an easy way to accomplish the important goal.

The Bond Buyer

By Jack Casey

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