THE IMPACT OF THE DODD-FRANK ACT ON MUNICIPAL FINANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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Friday, July 20, 2012

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THE IMPACT OF THE DODD-FRANK ACT ON MUNICIPAL FINANCE

Friday, July 20, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:32 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Lucas, Manzullo, Campbell, Posey, Hurt, Dold; Maloney, Moore, and Ellison.

Ex officio present: Representative Frank.

Chairman GARRETT. Greetings. Good morning, everyone. The Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order. Today's hearing is entitled, "The Impact of the Dodd-Frank Act on Municipal Finance." I thank the Members who are here. As chairman of the Agriculture Committee, everything is all wrapped up on the farm bill, focusing your attention like a laser beam on these other issues. So I appreciate your joining us today.

Mr. LUCAS. Will the gentleman yield for just a moment?

I know the support that is building within your very veins to vote for the farm bill will be incredible when the moment comes but—

Chairman GARRETT. We are working on it.

Mr. LUCAS. I look forward to that. Thank you, sir.

Chairman GARRETT. We are working on that. And I also thank the entire panel for being with us here this morning as well. We have a fairly large panel, but that is good. We will turn to you shortly, but we will begin with opening statements.

And so, I will yield myself 3 minutes.

Today's hearing will examine the impact of the Dodd-Frank Act on municipal finance. The size of our Nation's municipal securities markets is close to $3 trillion. States, counties, cities, and other municipalities use this market to fund things like roads, bridges, schools, hospitals, and much more. Our local leaders rely on the municipal bond market to gain critical access to investment capital needed to finance these very important projects.

The Dodd-Frank Act enacted basically sweeping regulatory expansion over the municipal securities market. And while I support additional transparency—we all do—and accountability with all market participants, it must of course be balanced with the need to ensure that local governments, schools, and hospitals can still have the appropriate access to the marketplace.

So Title IX of the Act includes a number of provisions that will significantly alter the way much of the business in this market is conducted. Section 975 of the Dodd-Frank Act requires municipal advisors to register with the SEC now and provide new rule-writing authorities to the Municipal Securities Rulemaking Board (MSRB). So just defining a municipal advisor is critical. Because once a market participant has defined an advisor, those market participants are subject to a statutory fiduciary duty and additional anti-fraud provisions, as well as registration in the new—and the MSRB rules.

The SEC released their first draft of this rule back in December of 2010. After over 1,000 mostly negative comment letters were received, the SEC has now gone back to the drawing board to attempt to redraft a more workable rule.

And so in this regard, I commend you and Chairman Schapiro for acknowledgment of the initial overreach of the agency. I look forward to her working with us to address these significant concerns that market participants have raised.

Now one Member, I should also point out here, has specifically been working on this topic diligently from the outside, and he is right down at the end, Mr. Dold. Thank you for your work. You actually have legislation in this area, H.R. 2827. And what that does—and I am sure you will speak on it shortly—is attempt to provide much more clarification around the requirements of Section 975.

I really do appreciate that he has sort of taken the lead on this—taken the initiative to go into one of the areas that we have not had the opportunity to go into so far. So I thank you again for leading on this topic.

Today, we note that the congressional hearing with the Municipal Securities Rulemaking Board since this committee became the Financial Services Committee. Unfortunately, much of the oversight over the new limitation of Dodd-Frank that needs to be done because of the extensiveness of that, we have not been able to get into the examination in this area at the level that we would like to have.

So I think it is appropriate that before this committee and Congress give the agency new authority and responsibility, they at the very least have them before this committee in a formal manner to discuss what is being considered. As we have seen with so many other areas of Dodd-Frank, the increased breadth and scope of the Federal Government into parts of the financial market is tremendous.

We want to make sure that whatever rules finally come out, though they have the new authority, do not negatively impact upon them and the economy. Our municipal securities market is essential to the functioning of the local, State, and county governments.

It is important to get it right and I look forward to working again with the members of the panel, the stakeholders involved, and certainly Mr. Dold as well, the regulators and municipal communities for just that purpose, to make sure that we get it right.

And with that, I will yield back.

Welcome, and good morning. I recognize the gentleman, Mr. Ellison, for 3 minutes.

Mr. ELLISON. Yes, thank you, Mr. Chairman. I certainly appreciate the time.

And I want to thank the panel. I think this is a very important topic that we are addressing today. And from my standpoint, I would like to see us make sure that when we tweak the regulation, that we don't over-tweak the regulation. The fact is I don't support blanket assertions that we need fewer cops on the beat in the financial market. I think some of the things that we saw over the last few weeks have indicated the essential purpose of Dodd-Frank as we now approach the 2-year anniversary of the bill.

Not exactly on this topic, but on the general topic of Dodd-Frank, we have seen just recently that Barclays Bank paid a $455 billion fine for lying to the actual cost of the funds to LIBOR. Another 15 banks are being investigated. We have seen Wells Fargo settle a $175 million settlement with the Department of Justice for steering African-American buyers to high-cost mortgages. Bank of America, Countrywide, and Sun Bank also settled claims of a similar nature for enormous amounts of money. And of course, Capital One was fined $210 million for illegal fees charged to consumers by the CFPB.

Now that doesn't specifically have to do with the hearing today, but it does have to do with the general topic of whether or not we need more regulation of the financial markets. I would say that we need more than we have been getting over the last years and I think this makes me feel good about my vote in support of Dodd-Frank.

I think our topic today is important, but from my standpoint, I think it is a good thing to make sure we have more eyes on the problem, making sure that we have well-ordered, transparent markets in which investors, consumers, and municipalities can have greater confidence.

If you would indulge me as well, Mr. Chairman, I would like to make a special welcome to Mr. Alan Polsky who is my fellow Minnesotan. He hails from my district actually and serves as the senior vice president of Dougherty and Company, which is a Minneapolis, Minnesota-based investment firm. And he has worked with Dougherty and Company for 26 years. I am very proud that he is here today in his capacity as board chair of the Municipal Securities Rulemaking Board. He has played a national role in municipal finance both in his current position, and as chairman of the board of governors for the National Federation of Municipal Analysis.

And so, I am glad to have all of our witnesses, but I am particularly happy to have my own fellow Minnesotan here. I do thank you, and I welcome everyone to the panel, especially you, Mr. Polsky.

Chairman GARRETT. Thank you, and the gentleman yields back. Mr. Dold is recognized for 5 minutes.

Mr. DOLD. Thank you Mr. Chairman. I certainly want to thank you so much for calling the hearing, and I want to thank our witnesses for your time, your testimony, and your expertise today.

Local and State governments have issued over $3 trillion of outstanding municipal securities with individual retail investors directly or indirectly holding a large percentage of those securities. Our State and local governments rely heavily on the municipal securities market to finance hospitals, schools, physical infrastructure, utility facilities, transportation systems, and other capital projects.

An efficient municipal securities market must exist for our State and local governments to fund most of these critical capital projects. And as with any capital market, maintaining an efficient municipal securities market requires efficient, effective, and smart regulation.

However, until Dodd-Frank passed in 2010, one particular group of municipal securities market participants, nondealer financial advisors, remained largely or entirely unregulated. While most of these unregulated financial advisors were capable and honorable market participants, the absence of efficient and effective financial advisor regulations gave them unfair regulatory advantages over other market participants, while also allowing a few bad actors to remain in the business of advising municipalities, in some cases with devastating consequences to the municipalities, the taxpayers, and the ratepayers.

Fortunately, Section 975 sought to close that regulatory gap and to protect municipalities and their constituents by, among other things, expanding the MSRB's regulatory scope and by requiring these unregulated financial advisors to register with the SEC to become subject to SEC regulation and to become subject to the potential severe penalties for regulatory violations.

We have nearly unanimous agreement from everyone concerned—Democrats, Republicans, regulators, local governments, and market participants—that the municipal advisors provisions were a necessary improvement to our municipal securities regulation framework and will help protect municipalities from bad actors while also leveling the regulatory playing field for market participants.

However, while we have nearly universal support for the legislative intent with respect to municipal advisors regulations, we also have nearly unanimous opposition to the SEC's proposed rule implementing Dodd-Frank's municipal advisors provisions. In response to the SEC's proposed rule, the SEC received over 1,000 comment letters, most of which were highly critical. These critical comment letters came from State and local governments and market participants and from various other industry groups and individuals who would be improperly captured by a comprehensive regulatory framework, even though Dodd-Frank certainly never contemplated their inclusion—even though municipalities ultimately would be harmed by their inclusion.

The SEC Chairman herself has acknowledged these issues exist. In a response to my questions in a previous committee hearing, Chairman Schapiro testified that the SEC's proposed rule had cast a net far too widely, and that the SEC needed to make reasonable carvebacks and not to layer on unnecessary burdens.

Rather than protecting municipalities, the SEC's proposed rule would have the unintended and opposite effect of harming municipalities and undermining their ability to efficiently and inexpensively raise capital to operate their daily activities. For example, as

I have pointed out along with Chairman Schapiro and many of my congressional colleagues, the SEC's proposed rule would have the unintended effect of forcing volunteer appointed members of government boards and commissions into the comprehensive and burdensome SEC regulatory framework.

Bank tellers, bank branch managers, and their employees would become subject to comprehensive and burdensome SEC regulations simply by answering a city treasurer's question about available deposit accounts for holding bond proceeds. Engineering firms and accounting firms, insurance companies, and broker-dealers and their employees would similarly subject themselves to this comprehensive SEC regulatory framework simply by performing their own customary day-to-day services to their municipal clients.

The net result of the SEC's proposed rule would be fewer people and organizations willing to serve municipalities and higher costs for these same municipalities—all with no meaningful improvement in municipal protection. None of these potentially negative consequences were contemplated by Dodd-Frank's legislative intent or statutory text.

So for these reasons and with broad bipartisan support, I have introduced H.R. 2827, which would correct the SEC's proposed rule and give the SEC more precise guidance and clarify Dodd-Frank legislative intent and legislative text to ensure that we aren't unnecessarily harming municipalities and others who serve them, while maintaining protection for those municipalities.

I have been pleased to work with both Democrat and Republican colleagues and to receive bipartisan co-sponsorship from over 35 Members of Congress. However, we are not finished with our legislative process, and I think that it is important that we hear more from all concerned parties about the SEC's proposed rule and H.R. 2827's proposed clarifications.

As always, we remain open-minded and more than willing to listen to and work with all concerned—my colleagues, governments, local regulators, and market participants—to ensure that we get the best possible balance here.

H.R. 2827's objective is to maintain Dodd-Frank's statutory purposes and policies on protecting municipalities by ensuring that all municipal advisors are regulated by also minimizing the unintended negative consequences to municipalities and other market participants in light of the proposed SEC rule.

I understand that there have been some expressed concerns about H.R. 2827 removing the Federal fiduciary standard to instead leave in place the State fiduciary duty standards. I think that this is a legitimate point of discussion and we must clarify and carefully consider differing viewpoints on that topic. I also understand that some have expressed concerns about the precise language of the exemption clarifications and I am happy to consider all those concerns as well.

I thank our witnesses today for being here and for your testimony. I yield back.

Chairman GARRETT. The gentleman yields back. Thank you very much.

The gentlelady from New York is recognized for 2½ minutes.

Mrs. MALONEY. I thank the Chair for holding this hearing, and I thank all the panelists for your participation today.

As it stands, there are over $3 trillion in outstanding municipal securities within a market consisting of more than 55,000 entities and hundreds of municipal advisors consulting with States, counties, and cities on their investment decisions. Until the financial reforms were signed into law, many if not most municipal advisors were completely unregulated at the Federal level and their activities were unchecked.

This led to several high-profile cases of abuses like that of Jefferson County, Alabama, which defaulted just this past April on a $15 million payment to bond holders. With municipal security default cases like Jefferson County; Stockton, California; and Harrisburg, Pennsylvania; it is important to keep in mind the vulnerable state of these investments and the impact it can have on the economic viability of the municipalities that invest in them. The intent of requiring registration of municipal advisors in Dodd-Frank is to provide transparency and protection to a growing market.

After its initial proposed rule—municipal advisor rule—the SEC is currently reviewing over 1,000 comments showing the depth of concern on this matter. There have been many concerns raised about the scope of the SEC's rule, which SEC Chairman Schapiro has acknowledged. She has publicly stated that the Commission intends to tailor the final rule to address these concerns. That is why agencies have a rulemaking process. And that is why Dodd-Frank mandates a rulemaking to implement the direction to the SEC to require municipal advisor registration.

I am pleased to see the process working and I look forward to the comments of the panelists.

I yield back.

Chairman GARRETT. The gentlelady yields back.

We go to Ms. Moore for 2 minutes.

Ms. MOORE. Thank you, Chairman Garrett.

I want to thank Chairman Garrett and, of course, Ranking Member Waters for holding this important hearing on municipal finance.

And in fact, I would like to ask unanimous consent to insert a letter from Spelman College, on behalf of Ms. Waters, into the record. It is a comment on the registration of municipal advisors under Section 975 of Dodd-Frank.

Chairman GARRETT. Without objection, it is so ordered.

Ms. MOORE. Thank you.

Section 975 of Dodd-Frank provides, of course, enhanced protections for municipal security issuers, taxpayers, and ultimately for purchasers of municipal securities. I do agree, as others have already said, that this unregulated area created quite a problem during the financial meltdown. And I believe that Dodd-Frank struck an excellent balance and improved the integrity of the $3 trillion municipal market.

I also agree that there have been some serious concerns that the SEC says they are going to address with regard to their rulemaking process, their interpretation of Section 975 of Dodd-Frank, their definition of municipal advisors, and some other technical issues, including the application of the Volcker Rule. So I have joined my colleagues on a letter to the SEC asking them to address some of the problems with the proposed rules. And I hope that this hearing—I stayed over and didn't go home, because I am eager to hear and have an opportunity to be able to provide some clarification.

Prior to the enactment of Dodd-Frank, these so-called independent financial advisors operating in the marketplace, about 62 percent of them according to the MSRB, were unregistered firms in the marketplace. This was the issue at the heart of Section 975, to subject these independent municipal financial advisors to registration and to regulation, and to create uniform regulatory standards in the municipal market when acting in an advisor role to an issuer.

So I can see that my time has expired. I just want to thank Mr. Dold for his leadership on the issue. I look forward to working with this committee on the important legislation. And I look forward to the testimony of the witnesses.

Chairman GARRETT. The gentleman from Massachusetts is recognized for 2½ minutes.

Mr. FRANK. I first want to say that the most important issue, it seems to me, regarding municipal finance is one that we took some steps to dealing with, as the representative from Montgomery County mentioned, and that is the long-standing, wholly unjustified disparity in the criteria the rating agencies used in rating municipal securities.

Municipal securities almost never default. Even in the bankruptcies we have recently seen, the bondholders are getting paid. In Rhode Island, pensioners are getting put behind bondholders. Sensibly, because communities cannot afford the contagion that would be there.

And it has been very clear when the rating agencies rate corporate finance, they look at the likelihood of default. When they rate municipal finance, they look at, it seems to me sometimes, how well-dressed the members of the city council are, which is often not so good. And as a result, if you measure the ratings against the likelihood of default, the result is that municipalities pay an unjustified risk premium.

Now, I want to put something on the record. Being aware of that, and while I am trying very hard to change it, almost all of my personal investments are in Massachusetts municipal bonds, because they are double-tax exempt, and because the rating agencies inaccurately tell people that there is a risk of default, which is nonexistent.

It also seems to me to avoid a conflict-of-interest charge, because I can only be accused of trying to help the financial stability I have represented. So, that is one I intend to continue to work on.

On the advisor situation, I agree, and I thank the gentleman from Illinois who spoke on the Republican side. This was necessary. There were people taking advantage of municipalities. I have to say when people in Massachusetts said to me, "What do I do when there is this that they have offered to me that is so complicated I can't figure it out and I need help?" The answer is almost certainly to walk away from it. If it is too complicated for you to understand, it is probably not a good thing for you to do.

But they have the right to do it anyway. And that is why we need to have the advisors. But I also agree that the Securities and Exchange Commission rules were too restrictive. I had the benefit of a good conversation with Cam Fine, the head of the ICBA. And I would ask to put into the record a letter I sent on July 2nd to Chairman Schapiro, making clear that the normal activities of a bank in working with a municipality should not trigger a registration requirement. And only if they were actually offering active investment advice, or advising on how to structure the issuance, should they be an advisor. I think that the language—and I appreciate what appears to be in agreement—of the law does not support a more intrusive effort to put regular banking activities under this provision.

And I hope the SEC will listen to this. Legislation is always possible, but this is a case where legislation shouldn't be necessary, because the SEC should be listening to us and following the intent.

Thank you, Mr. Chairman.

Chairman GARRETT. I thank the gentleman.

For the final word on this, the gentleman from California is recognized for 1 minute.

Mr. CAMPBELL. Thank you, Mr. Chairman. I wasn't going to make an opening statement, but I feel that I have to, in my 1 minute, just make one comment relative to what the ranking member of the full committee just said, with which I could not disagree more.

Coming from California, where we have had three municipal bankruptcies—we probably will have nine more very soon—and looking at the new and I believe correct government accounting standard that once municipalities and a lot of special districts properly account for their pension health care obligations, many of them will be, on paper, insolvent.

Most of them, in fact, that I know of in California will likely be, on paper, insolvent. And I don't think we can presume going forward that, in bankruptcies, that these bonds, including State bonds of the State of California, which I have a great question about—and my disclosure would be I own absolutely zero municipal bonds or State bonds whatsoever in my portfolio—so that is my disclosure on this.

But I think we have great concerns about municipal bonds and government—

Mr. FRANK. Would the gentleman yield?

Mr. CAMPBELL. —State and local bonds going forward.

I would be happy to, with whatever—

Mr. FRANK. I would encourage—if I could have 10 seconds—that people not assume that because there is a bankruptcy, the bondholders are going to be in default—

Mr. CAMPBELL. But you can't assume—

Mr. FRANK. —what should be measured is the risk to the bondholders.

Mr. CAMPBELL. Reclaiming my time, you can't assume they are not going to be in default. And when there is as much trouble as there is out there in as many insolvent cities and special districts, this is a concern.

Mr. FRANK. I am sorry you don't have any, because I would have bought yours if you did.

Chairman GARRETT. And with that colloquy, we will now look to the panel. And perhaps, they will have a comment on this point that was just raised.

So we look to our first panelist. Mr. Geringer, welcome to the panel.

Oh, before I allow you to begin, many of you have not been on one of our panels before. You will each be recognized for 5 minutes, and your complete written statements will be made a part of the record.

We look forward to your summary within the 5-minute period of time.

Good morning.

STATEMENT OF THE HONORABLE JAMES E. GERINGER, CHAIR OF THE BOARD OF DIRECTORS, ASSOCIATION OF GOVERNING BOARDS OF UNIVERSITIES AND COLLEGES

Mr. GERINGER. Good morning, Mr. Chairman, and members of the subcommittee. I thank you for the opportunity to address the bill.

My testimony today is directed solely at a portion of H.R. 2827 dealing with the definition of municipal advisor, and in this case, as it relates to governing board members and staff of our higher education institutions. So I hope to simplify your work a little bit more this morning, Mr. Chairman, and focus in on a particular issue that is of concern to us.

I represent the Association of Governing Boards of Universities and Colleges. We have 1,900 member organizations, including Spelman College, and about 40,000 trustees as individuals who help govern those boards. I also serve as the Chair of the board of trustees of Western Governors University, a nonprofit that was organized 15 years ago, and I have served two terms as Governor of Wyoming.

The bill, H.R. 2827, addresses an issue that has been of great concern to colleges and universities, in fact, has probably sparked many of the negative responses to the SEC proposed rule. It is the effects of an overly broad definition of municipal advisor. The proposed rules would include all State and local governments in some capacity as part of the municipal definition, as well as certain private sector obligated persons. And the trustees of our higher education governing bodies would be included in this overly broad definition of municipal advisor.

To give you an idea, the MSRB would have to come up with some criteria, not only for the registration with the SEC of these individuals, but well over 100,000 people would have to meet some regulatory training or requirement of registration in order to serve. That would be an extraordinary burden and it is totally unnecessary.

We commend the SEC for clarifying in the proposed rules that elected board members of municipal entities, including our elected trustees, would not be required to register. But the proposed definition of municipal advisor would include appointed trustees of public universities, private nonprofits, and trustees of institutionally related foundations, because they are not explicitly exempted from the registration requirement.

So we support the goals of the Dodd-Frank Act and the SEC in their insurance of appropriate oversight, but we don't think it is necessary to have this needless, off-putting regulation of trustees acting in their fiduciary capacity. It would significantly impact our ability to recruit and retain the people who serve our higher education institutions, and certainly our Nation.

The regulation of the board of trustees is unnecessary, because they are a governing body, not an advisory body. The difference between, on the one hand, the ultimate governing body of higher education institutions; and on the other hand, an advisor to the institution is legally straightforward and basic to longstanding vital principles of institutional governance in higher education.

Regulation of the trustees' conduct under the Dodd-Frank Act would be not only contrary to legislative intent, it would be inconsistent with longstanding SEC interpretation of an advisor. And it is unnecessary because the conduct of trustees of colleges and universities and institutionally related foundations is already subject to a multitude of laws.

Trustees must comply with State not-for-profit corporation law; fiduciary duty laws; institutional policies, such as policies on conflicts of interest; State education law; the standards of accreditation bodies; the IRS rules for tax-exempt organizations; and multiple other regulatory regimes.

We don't need one more.

So for the reasons I have described, the Association of Governing Boards supports the provisions of Congressman Dold's bill, H.R. 2827, clarifying that certain persons acting in their capacity as elected or appointed members of a governing body are not municipal advisors.

But we note, however, that the language only exempts any elected or appointed member of a governing body of a municipal entity with respect to such member's role on the governing body, but does not similarly exempt elected or appointed members of a governing body of an obligated person.

It is that additional category that affects many of our trustees of private nonprofit universities, trustees of institutional foundations, and others.

We recognize that the exemption was likely drafted this way in light of the fact that the bill also narrows the general definition of municipal advisor to only include persons providing advice to a municipal entity and not to an obligated person.

But we suggest that you do amend the bill to include the definition of municipal advisor that would include people providing advice to obligated persons, as under current law. And I urge the committee to expand the definition to include elected or appointed members of a governing body of an obligated person, and to also expand to include the employees of obligated persons to ensure that staff members of private nonprofit universities and institutionally related foundations would not be considered municipal advisors.

Mr. Chairman, thank you for the opportunity to be here today.

[The prepared statement of Mr. Geringer can be found on page 63 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

Mr. Polsky is recognized for 5 minutes. And welcome to the panel.

STATEMENT OF ALAN D. POLSKY, CHAIR, MUNICIPAL SECURITIES RULEMAKING BOARD (MSRB)

Mr. POLSKY. Thank you. My thanks to our Congressman Ellison, and my thanks to you, Chairman Garrett, and the members of the subcommittee.

I appreciate the invitation to testify today on behalf of the Municipal Securities Rulemaking Board. My name is Alan Polsky and I am the current Chair of the MSRB.

The MSRB is the principal regulator for the municipal securities market. And as you know, the municipal market provides capital for government projects and operations and helps fund a variety of other public purposes.

Importantly, this market also creates jobs for the local economy. The Dodd-Frank Act directed the MSRB to protect State and local governments and establish regulations for municipal advisors.

These professionals advise State and local governments primarily on the issuance of municipal securities. They raise approximately $450 billion in the capital markets each year.

Municipal finance transactions can involve complicated structures, complex derivatives, and intricate investment strategies. As you can see by the chart over here on my right, these transactions also involve many service providers, advisors, and sales teams.

Municipal advisors play a critical role in helping elected officials assess complex financial transactions that can affect taxpayers for decades.

The other important point to note is that in almost all cases compensation on a transaction is contingent on its completion. This can create situations and incentives that put unknowing State and local governments at risk of inappropriate and unsuitable transactions and products, at the expense of taxpayers and ratepayers.

Financial Services Committee Chairman Bachus himself has noted that conflicts of interest and complexity in the municipal market can sometimes trap local officials unable to independently assess financing structures by underwriters.

Meanwhile, there is the potential for unqualified municipal advisors to recommend ill-advised or unsuitable transactions. These advisors can also have multiple undisclosed ties to other market participants that can threaten the integrity of their advice to State and local governments.

The Jefferson County, Alabama, bankruptcy, which has been mentioned, municipal bid-rigging convictions and unsuitable derivative transactions illustrate the price of gaps in regulation.

The MSRB is concerned above all with protecting State and local governments in the context of their municipal finance transactions. To carry out this mission, the MSRB reorganized its board of directors to include a majority of public independent members as well as municipal advisors. Their inclusion enables the MSRB to fully assess the risks, costs, and benefits of our rules to implement the law as it relates to municipal advisors.

Under the direction of this board, the MSRB has enhanced disclosure and transparency measures through regulations and enhancements to our public EMMA Web site. These changes protect investors, State and local governments, and the taxpayers who support that municipal borrowing.

As directed by statute, the MSRB has advanced draft rules for municipal advisors that would establish fair practice obligations, eliminate conflicts of interest, and address pay-to-play.

The MSRB is also establishing professional standards for municipal advisors. Our draft rules would promote conduct that is consistent with a municipal advisor's fiduciary duty to its State and local government clients.

Unlike other participants in a municipal finance transaction, municipal advisors act as a trusted advisor and have a duty of loyalty and care to their State and local government clients. MSRB rules will clearly articulate what is meant by this duty of loyalty so that State and local governments can understand the obligations of their municipal advisors.

I have a brief point now on the issue of the definition of municipal advisor. Like Congressman Dold, the MSRB is concerned about the effects of an overly broad definition and the need to avoid regulatory duplication.

We recommended several changes to the SEC proposal on the scope of the definition that are consistent with H.R. 2827. Our written testimony highlights these and suggests how Congress can avoid regulatory duplication without putting State and local governments at risk.

I hope I have provided the subcommittee with helpful information. And I would be happy to respond to any questions. Thank you.

[The prepared statement of Mr. Polsky can be found on page 102 of the appendix.]

Chairman GARRETT. And I thank you as well, and I appreciate your chart to put it in perspective as well.

Dr. Brooks, you are recognized for 5 minutes, and welcome to the panel.

STATEMENT OF ROBERT BROOKS, PH.D., PROFESSOR OF FINANCE, AND WALLACE D. MALONE, JR. ENDOWED CHAIR OF FINANCIAL MANAGEMENT, THE UNIVERSITY OF ALABAMA

Mr. BROOKS. Thank you. I am Robert Brooks, a finance professor at the University of Alabama. My area of academic work is financial derivatives and financial risk management, including municipal derivatives.

Thank you for the privilege of participating in this event. It is an honor for me to be here.

Before I make a couple of points, I would like to provide a perspective on the Jefferson County, Alabama, financial crisis to help understand my point of view.

Since 1998, I have used the 1997 swap transaction between Jefferson County, Alabama, and JPMorgan to train my students on how not to do a swap transaction. The 1997 swap idea was to refinance an existing variable rate bond with a fixed-rate bond, then enter into a swap transaction to create a synthetic variable rate bond.

The pitch book suggested significant savings in the form of lower interest costs. After millions of dollars of transaction costs and fees, the synthetic variable rate paid by Jefferson County was dramatically higher than the original variable rate bonds.

I am not aware of any financial institution that would refinance their own variable rate into a synthetic variable rate and take on more risk.

The broker of the swap on behalf of JPMorgan and Jefferson County had no independent advisor acting in a fiduciary capacity for Jefferson County. Although there were many independent advisory firms available to provide this service, Jefferson County officials did not want it.

Later, relying on the advice of other financial institutions, Jefferson County officials then proceeded to enter into over five billion notional amount of swaps tied to other failed strategies, based on a heavy debt burden.

Although there have been several prosecutions in Alabama, there has not been much apparent consequence to the financial institutions that facilitated this financial devastation.

Remember that at the time of this activity, Jefferson County, as well as financial institutions that facilitated this financial devastation, were heavily regulated entities.

I would like to focus on three points. If regulators frame financial risk management, then systemic risk will increase. Many concepts within financial risk management are not well-defined, hence, not well-understood. Remember that finance is a social science, not a physical science.

Market participants' beliefs about how certain financial instruments should be valued will influence their value. Most finance practitioners have a general understanding of "hedging" but it is surprisingly difficult to pin down.

For example, the 1997 Jefferson County swap transaction was promoted as a hedge of interest rate risk. Within a year, the 1997 swap transaction was terminated. If entering the swap transaction was hedging, what was terminating the swap?

Therefore, if regulators are allowed to forcefully frame the context of financial risk management, then systemic risk will actually increase and not decrease.

Next, hedging is ill-defined due to a lack of benchmarks specified in advance. The Dodd-Frank Act documents the following permitted activities for banks: risk-mitigating hedging activities in connection with and related to individual and aggregate positions; contracts and other holdings of a bank entity are designed to reduce the specific risk to the bank entity in connection with and related to such positions; and contracts and other holdings are permitted and hence referred to as a bona fide hedge.

Most banking entities have hundreds of positions with exposures to numerous market risks. These same firms have multiple stakeholders with different goals and objectives. There is no requirement in the Act and, for that matter, in other regulated regulations for firm-wide financial performance to be clearly defined in advance.

Therefore, almost any financial derivative transaction arguably can be deemed a bona fide hedge. All one must do is identify some existing exposure in the firm with the appropriate empirical correlation and voila, the derivatives transaction is a "bona fide hedge."

But from almost any ethical framework, such as the CFA Institute's Code of Ethics and Standards of Practice, many financial derivatives transactions today would not pass the "bona fide hedge."

They would be deemed deceitful and in bad faith.

Because finance falls in the social sciences, ethics is primary and analysis is accidental. Unfortunately for many in finance, especially academic finance, analysis is primary and ethics is accidental.

Thank you very much for the opportunity to be here.

[The prepared statement of Dr. Brooks can be found on page 40 of the appendix.]

Chairman GARRETT. And thank you, Dr. Brooks.

Mr. Doty is recognized for 5 minutes. And welcome to the panel.

STATEMENT OF ROBERT DOTY, PRESIDENT, AGFS

Mr. DOTY. Thank you, Chairman Garrett, Congressman Ellison, and members of the subcommittee.

My name is Robert Doty. I am a nondealer financial advisor, but I want to make it clear that I don't have any bones to pick with the dealer community. I think that it is an honorable community filled with competent, honest people.

I have long advocated the regulation of municipal advisors well before Dodd-Frank and, in fact, wrote letters to the SEC about that. And I am an advocate for a level playing field. I have been an underwriter, a dealer, a bond counsel, an issuer counsel, and I am currently a municipal advisor. I have worked on several billion dollars of successful transactions in about 2 dozen States in my career of over 40 years.

I don't accept contingent fees. And that gives me the freedom to advise clients not to create debt. And I have. I have told them not to go forward with transactions that I didn't feel that they could afford.

Here is what is at stake. There are 50,000 municipal entities out there that are issuers. I have talked with market participants. I think 500 is probably a high number to assume are sophisticated, and yet the SEC says these people have primary responsibility in their transactions.

But these issuer officials often don't know what to do. They are desperate for advice. They need unbiased, sound advice. Underwriters are very different because that is an adverse role. And they should not be regulated as municipal advisors in that capacity.

But there are tens of thousands of towns and villages and special districts, school districts, in your congressional districts. These are elected and appointed officials who want to balance budgets, fight crime, and control taxes, but they are not municipal finance experts.

When people like me appear before them, we make flowery promises. And they accept the promises and they rely heavily upon them. It is an unequal relationship, but they place great trust in us in connection with their bond issues and with their investment products.

The SEC made a big mistake by including them in the definition of "municipal advisor." They are the people who need protection. It is very important for all municipal advisors, dealers and non-dealers, to follow professional standards established by the Municipal Securities Rulemaking Board as our market's self-regulatory organization. There are many dealers on that board. There are issuers on that board and investors.

We need competency testing because competency is an issue in this market. And we need continuing education. That is not provided by existing rules. The existing rules are good, and I have no criticism of them, but they don't provide for competency, they don't provide for training, and they don't provide a means to get some of the bad apples out.

Another comment that I have on the bill—I have a concern with the last two lines that would allow municipal advisors to deal as principals. That is the direct opposite of what we should be doing. We should not be in there trying to cross-sell services. We should be trying to provide competent advice that is focused solely on our client and not in our own interests of how we can make more money. We need to look at the financial health of the communities, and we need to protect the taxpayers.

An example of cross-selling would be a financial advisor in a highly risky transaction wanting to do a feasibility study. They should assist the issuer in employing a good feasibility consultant, not try to make additional money out of the transaction. I think that violates the fiduciary duty.

Now on the fiduciary duty, the fiduciary duty is important for two reasons. It requires us to come forward with sound advice, not to remain silent, as happened in Jefferson County. Actually, in Jefferson County, there were two advisors. One was a bank and one was a nonbank. And what was missing was going in front of the entire board and warning them about the risks and defining those risks.

The other is the client's best interest. Dodd-Frank didn't invent this fiduciary duty. Here is what the Municipal Securities Rulemaking Board said in the 1970s: "A financial advisor acts in the fiduciary capacity as an agent for the governmental unit." They made several comments like that. The board was two-thirds dealers at that time. That was industry practice. That was Federal law.

It has been in effect for 3½ decades, and they were recognizing preexisting industry standards. State law is not satisfactory. SIFMA says the current system leaves States free to develop their own often conflicting definitions that confuse and lead to inconsistent definitions. I urge you, don't go backwards. Thank you.

[The prepared statement of Mr. Doty can be found on page 45 of the appendix.]

Chairman GARRETT. Thank you. The gentleman yields back. Mr. Firestine, good morning. Welcome to the panel, and you are recognized for 5 minutes.

STATEMENT OF TIMOTHY FIRESTINE, CHIEF ADMINISTRATIVE OFFICER, MONTGOMERY COUNTY, MARYLAND; AND PRESIDENT-ELECT, GOVERNMENT FINANCE OFFICERS ASSOCIATION (GFOA)

Mr. FIRESTINE. Chairman Garrett and members of the subcommittee, thank you for the opportunity to speak before you this morning. I am Tim Firestine, the chief administrative officer for Montgomery County, Maryland, which is located just northwest of the District. I also serve as the president-elect for the Government Finance Officers Association, which represents over 17,000 public finance professionals across the United States.

The Dodd-Frank Act includes a number of provisions that are of interest and that are very important to State and local governments. This is especially true with respect to those provisions that create parity between credit ratings, assign municipal and corporate securities, and regulate the derivatives market.

The importance of these two issues cannot be overstated and are discussed further in my written testimony. The entire community has been impatiently waiting for the SEC to finalize the definition of municipal advisor so that the MSRB can finally implement these important rules.

The SEC proposed a municipal advisor definition nearly 19 months ago that is unworkable in many ways. While a definition is needed to capture unregulated advisors who are hired by State and local governments, the SEC oddly and unhelpfully chose to address whether certain local government officials, employees, and board members should be included in this definition.

The proposal includes appointed members of State and local governing boards which, as you have heard from some of the other speakers, creates significant issues for us. Under the proposed municipal advisor definition, I myself could be defined as a municipal advisor because of my position as CAO of Montgomery County.

I also serve on the board of the D.C. Water and Sewer Authority, and chair its Finance and Budget Committee. We discuss multiple issues, including financial transactions involving both bet issuance and investments. It boggles my mind that my service as a member of a body that determines what should be done to meet constituent needs, including the hiring of finance professionals, could make me a regulated municipal advisor.

Congressman Dold's bill, H.R. 2027 attempts to remedy this problem by specifying that the definition does not include any elected or appointed member of a governing body. We support this exemption, but we do have concerns with other parts of the legislation.

The SEC's proposed definition could be interpreted as problematic when it strives to correctly cover currently unregulated independent financial advisors, but the way it is written, its proposed definition could also affect dealers who do not serve in an advisory manner.

The proposed definition could interfere with the types of discussions that may and should occur between dealers and issuers. It is important to note that dealers acting as dealers in a transaction play an important role in underwriting our bonds, and one where fiduciary duties should not apply.

Representative Dold's legislation clarifies these questions by suggesting various exemptions to the definition, but it opens the door too wide. In an attempt to make certain that underwriters are not categorized as municipal advisors, the legislation could leave issuers vulnerable when they use a financial advisor who is affiliated with a dealer firm or when an issuer engages in a transaction where, contrary to GFOA best practices, they choose not to engage the services of a financial advisor.

We have the same concern with excluding any financial institution or person associated with a financial institution. Such a broad stroke would appropriately exclude professionals within financial institutions such as trustees and professionals who provide traditional brokerage and banking services. But it also may exclude financial institution professionals who provide advisory services that should be covered by the definition and subsequent rules.

There must be a careful balance between the too-strict SEC proposed definition and the too-broad solutions found in H.R. 2827. Forthcoming SEC and MSRB actions must carefully and surgically be developed in order to correctly place new regulations on independent financial advisors and dealers when they are hired to serve as financial advisors on a given transaction, as those professionals should have a fiduciary duty to the issuer.

We are hopeful that in the course of their considerable delays with getting this accomplished, the SEC will have determined a reasonable definition that is workable and effective for all parties in the marketplace. Thank you.

[The prepared statement of Mr. Firestine can be found on page 50 of the appendix.]

Chairman GARRETT. And I thank you very much. Mr. Gibbs, welcome to the panel. You are recognized for 5 minutes.

STATEMENT OF KENNETH GIBBS, PRESIDENT, MUNICIPAL SECURITIES GROUP, JEFFRIES & COMPANY, INC.; AND MEMBER, BOARD OF DIRECTORS, AND CHAIR, MUNICIPAL SECURITIES DIVISION, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. GIBBS. Thank you, Chairman Garrett, and members of the subcommittee. I am grateful to be here, and grateful for your time.

I run the municipal securities business for Jefferies, but I am here in my capacity as Chair of the Municipal Division of the Securities Industry and Financial Markets Association. We are discussing the $3.7 trillion municipal bond market. It is a very special market. It is one of the most effective tools for financing the Nation's infrastructure. As has been mentioned, it serves over 50,000 distinct issuers of municipal securities. It is quite unusually global in its capacity to meet the needs of both multi-billion-dollar projects and $750,000 projects for a local school district in any of your districts.

Not only that, but the smallest of these issuers are able to access many different structures of financing to meet their needs—long term, short term, variable, fixed. And they can do it in very small size and at interest rates and transaction costs lower than in any other market. It is a phenomenal market, and it has also historically performed incredibly safely for the investment community with much better default statistics than any other debt market.

We are here today to protect that functionality and to talk about the regulations, in particular, that have been proposed with regard to municipal advisors. In December 2010, the SEC proposed a rule to implement the advisor regulation provisions of Dodd-Frank, which has raised many serious concerns. We are most focused in this testimony on the provision in the statute that excludes underwriters from the definition of municipal advisor.

The SEC has taken too narrow a view of the bond underwriting process. If the rule goes into effect as proposed, it could effectively prevent issuers from obtaining services, some of the best and most important services that they have historically gotten from the underwriting community, and which are commonly provided in association with the bond issuance and with the execution of their broader capital programs.

It is clear to us that Congress intended to exclude underwriters from the advisory definition, and the SEC's proposal goes against that congressional intent and their own statutory authority.

Representative Dold's bill, H.R. 2827, would make clarifications to the statute regarding advisory regulation to make it crystal clear that Congress intended for the new regulations to apply to previously unregulated municipal advisors, not to impose a conflicting layer of regulation on already heavily-regulated parties.

SIFMA supports H.R. 2827 and we urge the subcommittee to move quickly to advance the bill through the legislative process. I would parenthetically add that we are very supportive of Congressman Dold's comments with regard to some potential modifications to the bill.

Another important Dodd-Frank issue related to municipal finance is the Volcker Rule. When Congress enacted the Volcker Rule to prohibit proprietary trading and certain investments by bank funds, you added an exclusion from the restrictions for obligations of States and political subdivisions.

This exclusion is in there because of the safety of these investments and because the permission of this investment helps keep State and local borrowing costs low and the securities liquid.

Unfortunately, the Volcker Rule regulations proposed by the regulators would leave out over 40 percent of the market, all bonds issued by State and local government agencies and authorities.

It would also effectively prohibit tender option bonds, which are paid by those obligations and also assist in financing investor and dealer inventories, which again improves liquidity and keeps rates low.

Most importantly, Congress clearly intended to exclude the entire municipal market from the Volcker Rule restrictions, and any regulations should respect that intent.

Finally, Dodd-Frank imposes a new fee levied by FINRA on municipal securities dealers to pay the expenses of the Governmental Accounting Standards Board (GASB.) That funding scheme has weakness to it. It taxes the wrong people. The parties much closer to GASB aren't touched: investors; auditors; and even issuers. It is just dealers.

Secondly, it is not levied on bank dealers who are some of the most important market participants. Additionally, at the moment, it is now nice to be GASB. They simply make their funding needs known to FINRA and FINRA collects whatever GASB asks for, with no real oversight of their budget or activities.

It is a blank check. The funding model should be changed.

In sum, the municipal market can be an example of the process working. We urge the subcommittee to act quickly on H.R. 2827 and to revisit the GASB funding scheme enacted in Dodd-Frank.

We also urge you to pay close attention to the final Volcker Rule to ensure it respects congressional intent with regard to excluding State and local government bonds.

Thank you for the opportunity to present our views and contribute to successful implementation of congressional intent.

[The prepared statement of Mr. Gibbs can be found on page 66 of the appendix.]

Chairman GARRETT. Thank you, Mr. Gibbs.

Ms. Keck, welcome to the panel. And you are recognized for 5 minutes.

STATEMENT OF CHRISTINE KECK, DIRECTOR, GOVERNMENT RELATIONS, ENERGY SYSTEMS GROUP (ESG)

Ms. KECK. Thank you, Mr. Chairman.

Chairman Garrett and members of the subcommittee, my name is Christine Keck, and I am an executive with Energy Systems Group, known as ESG.

On behalf of ESG and the energy services industry, known as the ESCO industry, I appreciate the opportunity to share my views on H.R. 2827 and the rulemaking currently under way at the Securities and Exchange Commission regarding the registration of municipal advisors.

Energy Systems Group applauds Congressman Dold for the introduction of his important legislation. The Dold bill is a positive step in addressing the impact of municipal advisor registration to the ESCO industry.

At the core of our concerns, the proposed rule too narrowly defines the advice of the engineering exclusion that the engineering exclusion would cover. The advice and services ESCOs provide to customers are inexorably linked, and as such, should be excluded from the definition of municipal advisory activity.

We are seeking a rule that properly defines the term “engineering advice,” by recognizing the inexorable link between the continuum of services ESCOs provide and, in the end, appropriately excludes ESCOs from the requirement to register as municipal advisors.

A little bit about my company, Energy Systems Group—we are an award winning and nationally accredited energy services company that develops energy and infrastructure solutions for a broad range of customers, including municipalities.

ESG is wholly owned by Vectren Corporation, an energy services provider based in Evansville, Indiana, which serves more than one million customers in Indiana and Ohio.

ESG has implemented approximately $250 million of energy and infrastructure improvements for municipalities. On average, municipal work accounts for nearly 25 percent of ESG's annual business portfolio.

Public sector entities, including municipalities, look to ESCOs to address their energy maintenance and infrastructure needs through projects that generate sufficient energy and cost savings.

When deliberating about the specifics of a project, ESCOs can provide critical information municipalities need to make qualified judgments about the pros and cons of the proposal.

This valuable information can include energy audits, cash flow analysis of projected savings, and general material on available funding options, among other data points.

Simply put, a potential customer left without this information cannot make an informed judgment about whether to proceed. The statutory definition of municipal advisor specifically excludes engineers providing engineering advice.

We believe the intent of Congress was clear in that engineering services by their nature involve the provision of project-related economic information; and, therefore, engineers providing engineering advice should be excluded from registering as municipal advisors.

However, the SEC's proposed rule effectively would place outside of the statutory exclusion the majority of situations in which ESCOs work with local governments.

The SEC has stipulated in its proposal that cash flow modeling or the provision of information and education relating to municipal financial products would be deemed municipal advisory activity.

Absent the ability of ESCOs to discuss the cost, savings, and financing options of a potential energy project, the discussion of engineering itself essentially is useless to a customer.

It is simply impossible to disentangle information about engineering and the different processes and technologies available to save energy from the cost of that engineering, the savings that engineering can provide, and the options for funding that engineering.

Adoption of the proposed SEC rule would threaten the very nature of the ESCO industry and significantly impede our ability to undertake municipal projects that save taxpayer dollars, reduce energy usage, and create jobs.

The Dold bill seeks to remove ESCOs from entanglement in a registration regime that was unintended and would be unnecessarily burdensome.

Our industry has engaged in very constructive dialogue with the SEC and we appreciate the Commission's willingness to consider the unique and complex nature of municipal energy services projects.

In conclusion, Mr. Chairman, I would like to thank you and Congressman Dold and the entire subcommittee for the opportunity to provide my views here today.

The outcome of this issue and the exclusion from registration by ESCOs as municipal advisors is critical to the vibrancy of the energy services industry and our ability to work with municipalities.

I welcome any questions the subcommittee may have. Thank you.

[The prepared statement of Ms. Keck can be found on page 78 of the appendix.]

Chairman GARRETT. Thank you, Ms. Keck.

Mr. Kelly, welcome to the panel, and you are recognized for 5 minutes.

STATEMENT OF ALBERT C. KELLY, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SPIRITBANK; AND CHAIRMAN, AMERICAN BANKERS ASSOCIATION (ABA)

Mr. KELLY. Chairman Garrett, and subcommittee members, my name is Albert Kelly. I am president and CEO of SpiritBank in Bristol, Oklahoma, and chairman of the American Bankers Association.

ABA appreciates the subcommittee's review of an important new rule that may soon be issued by the SEC. The rule will implement Section 975 of Dodd-Frank requiring registration of municipal advisors.

ABA strongly believes that Section 975 was not intended to cover banks whose activities are already highly regulated by Federal and State banking supervisors. Rather, we believe Section 975 was directed at unregulated entities that provide advice to municipalities.

Requiring banks to register as municipal advisors would subject them to a wholly unwarranted and different securities-based regulatory regime on top of the current comprehensive bank regulatory regime.

The problem is compounded by the fact that the SEC proposal goes far beyond just advice related to the securities activities of State and local governments.

It would regulate advice concerning all "funds held by or on behalf of a municipal entity." As you know, banks have for decades provided a full range of products and services to municipalities.

These services include traditional bank products such as deposit accounts, cash management services, and loans.

By going far beyond the statute, the SEC's proposal would capture nearly every bank and every employee who gives such advice and force them to register as municipal advisors. Therefore, ABA fully supports H.R. 2827 introduced by Congressman Dold, which would clarify the focus on unregulated entities and remove banks from this ill-conceived proposal.

If the current proposal is adopted, the practical impact will be significant. Any bank employee who may give "advice" to local governmental bodies such as schools, libraries, and hospitals will have to register.

Let me give you a simple example of how onerous this new rule could be. Let us say a teller suggests to the small town city clerk to consider an interest bearing account rather than a checking account.

Since the proposal doesn't define the term "advice," that teller would have to be registered as a municipal advisor. Think of all the bank employees who provide information and advice concerning traditional bank products. The burden and cost of this duplicative regulatory scheme is enormous.

Consider another example. Banks, through their trust departments, often serve as advisors to municipal pension plans. These plans are not related to the municipal securities activities nor do they contain the proceeds of municipal securities issuances.

Nevertheless, banks that advise these pension plans would be required to register as municipal advisors under the proposal. Banks provide this service through their trust departments.

Bank trust departments are regularly examined to ensure they are in compliance with the highest fiduciary standards. In fact, bank trust departments, indeed, all bank activities are examined far more frequently than the investment advisors regulated by the SEC.

In addition, many bank products and services offered to municipalities are overseen by State treasurers. It serves no public purpose to add an additional layer of securities law regulation to such comprehensive bank supervision and examination.

The consequences would be severe. The registration reporting and examination requirements would be very costly, particularly for community banks. Some banks may decide to stop providing basic banking services to municipalities. This means that local governments will have to go outside their communities for something as simple as a bank account.

This is particularly true in small towns, such as those in my State of Oklahoma. ABA strongly urges this committee to pass H.R. 2827, and to conduct oversight of the SEC as it goes through the process of issuing the final rule. Such oversight would ensure the results do not impose unnecessary costs and unintended consequences. Thank you for allowing me to testify today.

[The prepared statement of Mr. Kelly can be found on page 83 of the appendix.]

Chairman GARRETT. Thank you again, Mr. Kelly.

And last, but not least, Mr. Marz.

STATEMENT OF MICHAEL J. MARZ, VICE CHAIRMAN, FIRSTSOUTHWEST; AND MEMBER, BOARD OF DIRECTORS, THE BOND DEALERS OF AMERICA (BDA)

Mr. MARZ. Chairman Garrett, and members of the subcommittee, I am Michael Marz, vice chairman for First Southwest Company based in Dallas, Texas. I am also a member of the Bond Dealers of America, BDA. BDA appreciates the opportunity to testify.

Based in Washington, D.C., BDA represents the unique interests of middle-market, sell side, fixed income dealers. Bond dealers like First Southwest are a bridge between public infrastructure and investors. These types of public projects happen every day, and if the bond issuance occurs with the prudent advice of members such as BDA, the public citizens can save money.

BDA supports the Dodd-Frank provisions that: one, require the Securities and Exchange Commission to adopt rules requiring unregulated municipal advisors to register; and two, require the Municipal Securities Rulemaking Board to regulate activity of municipal advisors. The SEC and the MSRB so far have failed to finalize their rules on these provisions. Today, virtually anyone can act as a nondealer municipal advisor regardless of qualifications.

It seems exactly the opposite of what Dodd-Frank intended. In order to protect public interest, regulators need to create a level playing field by regulating municipal advisors under rules similar to those already imposed on regulated dealer advisors. In October 2009, SEC Commissioner Elisse Walter said that some unregulated municipal advisors were engaged in play-to-prey practices, failing to disclose conflict of interest and failing to place the duty of their clients ahead of their own interests.

Unregulated municipal advisors have been represented in high-profile public finance disasters such as the bankruptcy of Jefferson County, Alabama, in bond deals in New Mexico, fraught with play-to-prey improprieties, and bid rigging that lead to the conviction of unregulated municipal advisors. There are two steps to preventing such disasters from occurring. The first step is for the SEC to get the definition of a municipal advisor right. The next critical step is for the SEC and the MSRB to regulate independent municipal advisors.

With respect to the definition of a municipal advisor, the SEC has publicly admitted that its proposed definition is overly broad. The BDA recommends that the SEC permit an underwriter to use a disclaimer to disclose to other parties that it is not acting as an advisor. The broker-dealer should not be considered a municipal advisor if he or she is acting as an underwriter, if they are not being compensated for financial advice and disclose that the participation in the transaction is arms-length and if they are not a fiduciary to the issuer.

Once the SEC has identified the appropriate definition of a municipal advisor, the next step is to regulate the currently unregulated advisors. Although dealer advisors and unregulated advisors will play similar roles in advising bond issuers, their level of regulation is dramatically different. Allow me to read a few requirements from my testimony that describe what registered broker-dealers are subject to, as opposed to what is not required of unregulated advisors.

This includes MSRB SEC regulations, audit compliance reviews, license requirements, continuing edit testing, restrictions on political contributions, gifts and entertainment, requirements for record retention, obligation requirements for fair dealing, disclosure, compensation of third party fees, and conflict of interest. As you can see, dealers like myself are heavily regulated even beyond the regulations that apply to customer accounts. Unregulated municipal advisors simply lack enforcement of any regulation and a level playing field of regulation must be implemented.

These unregulated municipal advisors assist in structuring bond issues, determine the fair value price for an issuer to help select underwriters as well as provide investment and swap advisory services. It is high time that the Commission get their definition of municipal advisors back on track. I appreciate that many members of this committee want to be involved in that solution.

Last year, Congressman Dold introduced H.R. 2827 to more clearly define the scope, especially narrowing the definition of a municipal advisor by already excluding dealer advisors, elected and appointed officials, and others from the definition.

Clarification of the definition of a municipal advisor is a strong step in the right direction. Equally important is the need for there to be a set of regulations parallel to those already embraced by regulated dealer advisors. These steps will ensure that unregulated municipal advisors act in the interest of their clients, thereby leveling the playing field with regulated dealer advisors to protect the public.

I appreciate the opportunity to testify.

[The prepared statement of Mr. Marz can be found on page 91 of the appendix.]

Chairman GARRETT. And, again, I thank you, and I thank the entire panel for your testimony. It was very interesting.

We will begin with the questioning, and I will start.

First of all, my takeaway from the panel and this discussion, generally speaking, is therefore the absolute necessity of Mr. Dold's legislation in light of what we have just heard here. We have heard some recommendations as well for potential modifications of the legislation.

I think the gentleman is looking forward to considering those. I will yield to the gentleman.

Mr. DOLD. Absolutely. I think that in conversations not only with some of the panelists, but also with my colleague Ms. Moore and others on the other side, that there are some things we need to consider and take into account.

Chairman GARRETT. I am going to take a step back from the specific legislation for a minute and just look at the problem and the scope of the problem, which we really didn't get into too much.

Mr. Doty, maybe you talked about it a little bit. Try to put it in perspective for me, okay? So there are what, 50,000 issuers out there across the country? Mr. Marz and a few others talked about some of the newsworthy, noteworthy cases that have come down of late in the press.

There are one or two or three. But first of all, what is the number? So there are 50,000 issuers. How many deals are actually made on a yearly basis or on a 10-yearly basis that are out there? Is there any ballpark number that we are looking at?

Mr. Gibbs?

Mr. GIBBS. 15,000.

Chairman GARRETT. 15,000 a year? So over a 10-year period, 150,000 to 200,000 deals are actually out there, about 150,000. We have heard about two or three of these settlement cases. Are there a lot more cases that I am just not hearing about? Because 2 or 3 out of 200,000 is not very many.

Mr. DOTY. There really are very few defaults.

I would like to explain the difference between a general fund obligation and a general obligation bond, which are vastly different. But there really are very few defaults overall. There are certain specific market sectors that have much higher rates than default. They don't get into the newspapers very much. Land secured transactions. Nursing homes have a higher rate of default and so on. But the traditional governmental securities virtually never default. There are extremely low default rates overall for governmental traditional securities.

Chairman GARRETT. Okay, so that is the classification of the default. And how many cases do we have of the Jefferson County case which is a default and a pure fraud situation? Because there are other reasons for a default that are not fraudulent where it has nothing to do with having bad investment advisor here. It is just the economics of the municipality or the deal.

So what are we talking about as far as—put it in perspective just in the sense of the real problem that Dodd-Frank was dealing with here.

Mr. DOTY. In the traditional governmental sector, I would say that if you look for start-up projects, Harrisburg is a good example of a start-up project. There was one up in Michigan—or Wisconsin, I forget which—the steam utility and so on. There, the feasibility study is key. And that is where the issues are. These really don't get into the New York Times or the Wall Street Journal. They are in the Bond Buyer, but there are a few of those around.

And if you are looking at the traditional governmental sector putting aside some general fund issues relating to pension obligations and so on, start-up projects are where it is going to be.

Chairman GARRETT. Again, just so I am getting a picture of what the market is like, what the problem is really like, so we have had these, I will say notorious cases that you refer to. But they, of course, were prosecuted. They were prosecuted I guess under securities fraud legislation and State fraud legislation. So those laws are already on the books for those cases.

So was the bottom line—are the regulations that have effectually came about because of Dodd-Frank and the way the SEC have done—simple way of putting it—is it overkill in light of the level of the problem that really exists out there, or not?

Mr. MARZ. Chairman Garrett, if I may?

Chairman GARRETT. Yes?

Mr. MARZ. This is not really an issue so much of default; it is a lack of advisors who don't have competency and testing and—

Chairman GARRETT. Well, that is my question. How does this show just what that level of lack of competency is and how is it translated into actual—not necessarily defaults but poor—

Mr. MARZ. —higher costs.

Chairman GARRETT. Higher costs. Is there data to show it is a—

Mr. MARZ. Yes. It is certainly not something that has been litigated, but it can be apparent.

Chairman GARRETT. What—

Mr. DOTY. —Congressman, if I may interject, I agree with what he said. He is a dealer and I am not a dealer, but I think competency is a big issue. It is not just whether you are going to have a default—

Chairman GARRETT. right.

Mr. DOTY. —it is what is the pricing of the bonds? How do these bonds work for this issuer? Have you negotiated the best terms?

Chairman GARRETT. right—

Mr. DOTY. —There is a big competency issue.

Chairman GARRETT. Should the SEC re-propose a new rule so you have an opportunity to formally comment on it before they go forward with the final rule? In other words, should we have a new rule proposed before simply coming forward with the final rule? There is a general consensus of "yes."

Okay. With that, I thank the panel.

I will yield to the gentlelady from New York.

Mrs. MALONEY. Thank you.

And I thank all the panelists.

I would like to ask Mr. Doty and Professor Brooks and Mr. Marz to respond to this. And then, I have a secondary question.

Investment advisors for individuals are already held to a fiduciary standard, meaning a duty to serve the best interests of their client, including an obligation not to subordinate the client's interest to their own. This is a higher standard than the suitability standard, which simply requires that the recommendations of the broker be consistent with the interest of the customer.

Is there any reason, in your opinion, that investment advisors to municipalities should not also be held to a Federal fiduciary standard?

Mr. Doty, Professor Brooks and Mr. Marz?

Mr. DOTY. You said investment advisors. Do you mean investment advisors as opposed to financial advisors? Or are you talking about investments?

Mrs. MALONEY. I am talking about—yes, both. Aren't they both advising the municipalities on what are sane and safe investments? And—

Mr. DOTY. I don't want to hog the discussion.

Mrs. MALONEY. If you could respond, please. My time is very limited. Very quickly?

Mr. DOTY. Yes, I am sorry.

As I said, I think there has been a fiduciary duty all along. I think it goes back to the mid-1970s when the MSRB made those statements. And as I said, at that time, it was two-thirds dealers, and they were the ones making the statements. And I think there has been—

Mrs. MALONEY. Thank you.

Professor Brooks?

Mr. BROOKS. I think that the key thing to understand here is that the industry supplies what the industry demands. And so historically, the industry has demanded transaction-based, nonfiduciary framework. And what the industry needs to demand is a fiduciary-based advisory—somebody on my side of the table—to represent the interests of the municipality. And that would cure this problem.

Mrs. MALONEY. Okay.

Mr. Marz?

Mr. MARZ. Yes, madam. I do agree with you. The regulated dealer advisor and the regulated investment advisor have similar standards. And it is the underregulated advisor that has been left out of this and needs to have requirements and testing similar to the two that are currently regulated.

Mrs. MALONEY. Okay.

And the MSRB, Alan Polsky?

Mr. POLSKY. Yes, thank you.

I think that, as the other gentlemen have suggested, if you recall the chart that was held up earlier, there are so many parties to the transaction. And the municipal advisor fills the key role of being the one who is not at arm's length. It is that duty and loyalty and care and that trusted advisor relationship that is really critical to a lot of the problems that have been suggested here. Who has their best interests in mind?

I think that is what we would like to get on with having that discussion and moving forward when we have a definition in place.

Mrs. MALONEY. I would like to ask the representatives from the ABA, SIFMA, and the MSRB to respond to this question.

The SEC recently extended the compliance date for its temporary municipal advisor registration rule until September 30, 2012. Has the SEC been using the time provided by the extension to engage with your organizations to make sure that the municipal advisor rules are workable for the industry, while also providing the protection that we wanted to put in place under Dodd-Frank reform?

Mr. POLSKY. I will go first. Beginning in 2010, immediately after Dodd-Frank was passed and our board was reorganized, we began working on a set of core rules for municipal advisors that included conflicts of interest, pay-to-play, supervisory rules, and professional qualifications. They were done very publicly.

We began the comment process for that, and withdrew those rules because of the lack of a definition. We have had many conversations, as I think everybody at this table has, with the SEC about the definition. Comment letters have gone in and I don't know where it stands beyond that. But we have moved forward on it as best we could.

Mrs. MALONEY. Okay.

Mr. Kelly?

Mr. KELLY. The ABA has engaged several times, myself included, in discussions explaining that this was overly broad and the impact that we believed this would have by having Betty the teller have to register as a municipal advisor simply because of the example that I used. We have repeatedly requested that be addressed and that there has been an acknowledgement of our level of concern, and that has been overly broad. But our belief is there has been an unwillingness to do that, absent direction from Congress.

Mrs. MALONEY. And SIFMA, very quickly. Yes?

Mr. GIBBS. It has been very unclear to us where they will come out on the underwriter exception, and whether they will let go of how narrow they started.

Mrs. MALONEY. My time has expired.

Thank you.

Mr. DOLD [presiding]. The Chair recognizes the gentleman, Mr. Lucas, for 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman.

In May of 2009, Martha Haines, the head of the Office of Municipal Securities, told this committee that establishing an effective registration and examination program for municipal advisors would be easy, because only 260 nonbanker dealer municipal advisors existed. Now clearly, her estimate was wrong, and clearly the nature of the rule proposed in Dodd-Frank Section 975 is going to reach out and capture thousands of individuals.

So if I could, Mr. Kelly, in addition to representing your national association, you are a real-world banker back home. You participate in the more sophisticated Tulsa market, but also in much of rural northeastern Oklahoma. And you have commented on the effect that this broad thing would do.

Could you expand for a moment, if the rule is not addressed, if as you said, it applies to Betty the teller, then what is going to be the response of financial institutions like yours across the country?

Mr. KELLY. Given the very close relationship that my rural banks have with their communities, some communities in which we are not in that don't have banks—

Mr. LUCAS. The longstanding level of trust that in many cases goes back decades; correct?

Mr. KELLY. Absolutely. It goes back many decades. And of course, the need for the banks to support those activities that make a community, that make life being able to be lived. Should we, pursuant to our charter, continue to provide that level of banking service as we have to all of our communities. We believe that out of our 300 employees who stretch through northeastern Oklahoma, we have a minimum of 100 of them that we would have to register, and possibly up to 150.

The problem that creates is, as you know, they would have to then take a test that shows that they are competent to do, which they have no real training in, and just saying go over and open an account, which is all they do. And so, the question then becomes if we would leave that market depending on how much, how complicated that becomes.

And the difficulty that is going to impose, as well as the expense that is going to have, because we have to pay every year for every registration. The concern that we have is that this is one more layer on an already tremendously large burden that all of our community banks are having.

And frankly, in talking with some of my colleagues, they are planning to just withdraw from the market, basically saying, you are going to have to go get your municipal deposits handled in another place, because they are fearful of opening the door to yet one more examination.

I also would say that, just as an aside, some of my folks serve on various and sundry boards. They too would have to be registered, not because they are Betty the teller, but because they are volunteers. One of them is a volunteer mayor. So they would have to be registered if they are going to continue to perform those duties.

Mr. LUCAS. So ultimately, the loss is to municipal and local government and a lack of expertise that they have a level of trust with now—

Mr. KELLY. It would—

Mr. LUCAS. —of resources?

Mr. KELLY. At worst, it would drive many of us who have been allies and friends as well as providers of banking services to these municipalities out of the ability to do that. And sadly, that will tear the fabric of those communities as well as the robust nature of banking in the communities.

Mr. LUCAS. Thank you, Mr. Kelly.

I yield back the balance of my time, Mr. Chairman.

Mr. DOLD. The gentleman yields back.

The Chair recognizes the gentlewoman from Wisconsin, Ms. Moore, for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

And just let me say how much I am appreciating this panel with a very complicated topic. And also, I want to appreciate the current Chair, Mr. Dold, for his hard work in working with me, working together on this.

I guess I have been asking, as well as I listened to your testimony, there have been a lot of things that have occurred to me during your testimony that I would like to clarify in my brief time.

I want to start out with Mr. Doty and maybe SIFMA and others. The Dold bill does take away the Federal standard. So would you be in favor of retaining the Federal fiduciary standard? I think Mrs. Maloney was trying to get at that.

And then, the second question I have for SIFMA, the MSRB, and others is if we were to just maybe return to the Federal standard and add language to the definition of the municipal advisor, something like, "in the business of providing municipal advisory service." Add that in. Similar to other securities law principles that, instead of excluding broker-dealers from Section 925, but simply adding that language into the definition of an M.A., then of course the MSRB rule G-23 would kick in and that would clarify it.

I know Mr. Dold is interested in working this through. Do you think that might be a way to satisfy some of the many concerns that you all have raised today?

I will start with Mr. Doty, and then each of you can consume my time by responding.

Mr. DOTY. I would be very troubled by taking out the fiduciary duty and I would—

Ms. MOORE. But it is. I am saying the Federal for the restoring that in the Dold bill.

Mr. DOTY. I would not delete that.

And I would also look at those last two lines about dealing as a principal. I think you have something in mind, but I would be more specific about what that is, because right now it is unqualified and I don't think it is a good idea.

The recent action by the MSRB on underwriter disclosures, which is becoming effective here in a couple of weeks, requires underwriters to make a lot of disclosures about their role to issuers and including that they are adverse parties that are not obligated to act in the best interest of the issuers and so on.

And so, I think that provides some support for a broader concept of underwriter exclusion but not for all broker-dealers across-the-board. Because I think that in both the dealer and nondealer communities, there are people who could benefit from competency training, some continuing education. I think that over time, that would be very good for the issuers and the testing and the professional standards to guide them. There are a few bad apples in both. And that is not to cast aspersions on either group, but I think both need improvement. I just continue to have this concern about a level playing field, that we get this regulation in place.

And I do want to comment that if the SEC re-proposes it, since they are taking so long to come out with a new proposal, then that is just going to delay this whole thing, and I fear delay it another year.

Ms. MOORE. Okay, can Mr. Gibbs—yes, please.

Mr. GIBBS. We would be pleased to work with you on the fiduciary concept.

I think the thing actually that is most essential is uniformity. And with the structure of our market, I believe strongly the MSRB is in the best position to provide the guidance as to what the meaning of the fiduciary responsibility is.

And they are in the position, once the definition of who is an advisor is settled, to make sure that dealers and nondealers are subject to a uniform standard.

Ms. MOORE. Okay. Mr. Polsky?

Mr. POLSKY. Thank you. Yes, if I could just follow on Mr. Gibbs' comment.

I think that you touched on two very important points. We have approached it from a scope-based analysis of really how an investment advisor works in their capacity.

And you are absolutely correct to suggest that G-23, which was changed last year to prevent an underwriter from acting as an advisor on the same transaction, really does bring that point home and I think should give some support to the marketplace and to this subcommittee that role-switching won't go on.

Ms. MOORE. Okay.

Mr. Chairman, with your indulgence, I just want to comment that I do think that we can work things out and give the SEC some guidance, given this expert testimony that we have had today and our understanding of some of the problems that they have seen.

I yield back.

Mr. DOLD. I appreciate that the gentlelady yields back, and I would agree that I think there are some areas that we can refine prior to markup and hopefully we can get some more support, even, for what I think is an important piece of legislation.

The Chair recognizes the gentleman from California, Mr. Campbell, for 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman.

I don't have a specific question so much as a general observation upon which any of you may comment.

Clearly, I think where we are going here is—I think it is pretty clear from all of you up here that the existing regulatory structure has gone too far.

So the question is, where do we draw this line? Who is on one side of the line and who is on the other side of the line?

And necessarily for me, my judgment relative to that is colored by the fact that I am from California, whereas if I were from Oklahoma, like Mr. Lucas and Mr. Kelly, I might have a different viewpoint. But given where I am from, there is a lot of stress and a lot of strain and a lot of risk.

I understand, Mr. Doty, your comment about the history of failures. And by the way, I am a CPA. I do understand the difference between general obligation bonds and other bonds. So I do understand that.

But there aren't any failures until there are. Big investment banks that have been around for a hundred years didn't ever fail until Bear Stearns and then Lehman, and then they were all going to fail. And they had never failed and they were all going to fail.

And of course, we are seeing things in Europe now which weren't ever supposed to happen, and never have happened, and aren't supposed to happen to major countries. They only happen to third world countries.

And when I look at the situation in California, we have had three bankruptcies. We will likely have many more. A lot of this is being driven by pension obligations, as was suggested, and by health care and other employee obligations. And some of this is State law over which the municipalities don't have any control that is driving them into these problems.

I look sometimes at a school board, and you look at who is on the school board that is making these decisions and they are largely educators, which clearly makes sense. They are often paid little or nothing and they are part-time doing this.

And they are making decisions in an area in which they don't have a lot of background and expertise. So who is giving them advice? And the advice they are getting is pretty important, because they are making a lot of decisions relative—in large amounts of money in an area in which they don't have a lot of background.

So all of that concerns me, that as we look at this, we set up a structure under which those advisors and that advice is something that someone is looking at because I am not sure that a lot of them will have the ability to.

When I look at all of that, I say, we kind of have to be careful where we do draw this line. And as I said, given in California that I don't know where all this is going to go.

Sometimes, as you know, something doesn't fail, but because there is litigation, I assure you that many of these employee associations and unions and so forth are going to fight like crazy not to have their pensions and their things invalidated and instead to have the bondholders take a haircut.

And that may not be where the obligations lie in legal form, but the thing gets tied up in court for a long time, maybe a settlement gets made and so we know there are lots of cases where there can be adjustments made that aren't technically a default.

So I do think there is a lot of risk out there that needs to be taken into account as we review this. I used up almost all my time. If anybody would like to comment on any that, I would appreciate it.

Mr. MARZ. Congressman, I support exactly what you are saying.

And if the fiduciary standard is going to have teeth, then the people giving advice, the unregulated advisor that is taking care of the time of the bond sale, trying to tell the issuer if the price is fair. Part of the selection of underwriters—those people need to have regulations similar to what the broker-dealers do, unlike Mr. Kelly's bank teller.

Mr. DOTY. Congressman, I would like to point out, and you may not be aware, that virtually everybody in most municipal securities transactions, everybody is paid a contingent fee. Nobody gets paid unless that transaction closes. I was really happy to hear a reference in Mr. Polsky's testimony to the contingent fee.

I think it is problematic and I think it is not going to be possible to just ban it. But I think it is going to be possible to regulate it and encourage people to go in so there is somebody there talking to that municipality saying, maybe you ought to have second thoughts about going forward with this transaction. Because right now if anybody does that, they are not going to be paid.

Mr. GERINGER. Mr. Chairman, just one brief comment on Mr. Campbell's observations.

Mr. CAMPBELL. Mr. Geringer?

Mr. GERINGER. There almost seems to be an inference that elected officials ought to have competency training. So I think that is a different issue.

Mr. CAMPBELL. I will just say that I think expecting competency from elected officials may be a bridge too far. So that is why we should have better competency from the advisors. Yes?

Mr. POLSKY. One comment I would like to make—I think that under the board's responsibility to protect State and local governments, one of the things we spent a lot of time on over the last 2 years is trying to decide what that means.

And it is—much of this discussion about municipal advisors, of course, is key to that. But there is an educational component and a market awareness component that we have worked on very diligently as well. So I would have you not lose sight of those.

Mr. CAMPBELL. Okay. I am way over my time. I thank you for your indulgence, Mr. Chairman.

Mr. DOLD. I certainly thank you for the questions and the responses there.

The Chair recognizes himself for 5 minutes for the purpose of questioning. And I want to start out—and my colleague, Ms. Moore, who has been certainly instrumental in H.R. 2827, has just stepped out but I certainly want to recognize her for her help and support.

And I certainly appreciate you taking your time to be with us today, and I certainly appreciate the insight that you have provided.

Mr. Kelly, I certainly take note and I think it is probably not unique when we talk about how overly broad legislation, or at least some lack of clarity there, will prevent banks or will make banks start to walk away from this whole municipal advisor or even dealing with municipalities, which I think would certainly hurt municipalities and end-users.

I do want to ask Mr. Gibbs really quickly if I could, what effect has the SEC's delay in finalizing the municipal advisor definition had on investors in municipal securities?

Mr. GIBBS. I think the delay really is more impacting the issuer community than the investor community, in that, as has been pointed out, the unregulated parties still aren't regulated.

And in turn those of us who are already regulated, who the overly broad proposals might touch, have begun to try and think through potentially curtailing our approach.

So there is some confusion and shuffling and some of the potential improvements that could be there have not been realized.

On the investor side, probably the biggest impact so far actually was the topic I mentioned second, which is the Volcker Rule, where firms are preparing to reduce their commitment to certain aspects of their portfolio and to tender option bonds, which provide liquidity in the market because of the form of the Volcker Rule that has been proposed.

Mr. DOLD. I am going to go to Mr. Polsky. Does the Federal fiduciary standard pursuant to Section 975 preempt State law? And if not, should it, to avoid having two arguably different fiduciary duty standards operating on the same person at the same time with respect to the same activities?

Mr. POLSKY. My understanding is that it does not, that the common law that exists across the States would still establish a fiduciary duty. However, the standardization or a single standard for the entire marketplace I think would bring some clarity, sort of following on Mr. Gibbs's comments about where we are, as far as the kind of advice that can be provided.

Mr. DOLD. Can you give me just an idea in terms of what an overly broad municipal advisor definition would have on the MSRB?

Mr. POLSKY. I think it would make our implementation of regulations that much more difficult if it was. So much of what we do, again, is scope-based or principles-based, if you will, and sort of the behavior.

So if you look at people's various business models, if it is too broad, if it is the teller in the bank on Oklahoma, clearly that creates a lot of regulatory duplication and uncertainty in the marketplace, which I don't think are the issues that we are trying to resolve today and going forward.

Mr. DOLD. Can you give us just a little bit more explanation about the scope-based approach that you would have on the exemptions in H.R. 2827, the proposed legislation?

Mr. POLSKY. I think when I talk about a scope-based approach, I am talking less about the activities than who the party is. So that whoever you are, if you are rendering municipal advice which involves the structuring, timing, covenants, whatever components of a transaction which are really critical to an underwriting. I think it is that kind of a relationship that in my mind is a municipal advisory relationship, as opposed to getting the specificity of, again, the teller or any sort of interaction or being a public member of a board, which is more troublesome.

Mr. DOLD. Okay. And I just have time for probably one more question to come right back at you, Mr. Polsky. Is it possible that the fiduciary standard for municipal advisors could conflict with other standards of care?

Mr. POLSKY. I would prefer to respond to that in writing.

Mr. DOLD. We would welcome the response in writing.

Mr. POLSKY. Thank you.

Mr. DOLD. The Chair's time is expiring, so the Chair recognizes the gentleman from Illinois, Mr. Manzullo, for 5 minutes.

Mr. MANZULLO. Mr. Chairman, thank you for having this hearing. Let me ask this question. It is pretty basic.

From the testimony that I have been able to glean from the written documents, and from watching some of this on TV in my office while I had other duties to do, there are somewhere around 40,000 individuals at 1,900 colleges, universities, and affiliated organizations—this is Mr. Geringer's testimony—who serve as trustees, and another 50,000 men and women who serve as—I am sorry.

There are about 90,000 people involved, is that correct, who serve as trustees at schools and universities?

Mr. GERINGER. Yes, that is true overall. The membership that we include is the lower number, around 40,000. But if you counted the foundation boards, there are about 45,000 involved. There are 50,000 trustees overall who are elected and appointed, predominantly appointed. So that is just in the higher education community. It does not account for all the others mentioned here today, including hospital boards and various local government entities.

Mr. MANZULLO. My question is, what impact are these regulations going to have upon the availability and the willingness to serve of these trustees and future trustees who have to live under these regulations?

Mr. GERINGER. We view it as making it very difficult to recruit and retain anybody for appointed positions such as that. So it would discourage people from engaging and even serving in a volunteer capacity, which they do. They are not compensated.

And you take that pool of talent out of the way, particularly people who have some financial expertise who can hold the financial advisors and in effect the municipal advisors accountable. So you would lose the preponderance of people who are the most capable of serving on these boards of various institutions.

Mr. MANZULLO. Would anybody else care to tackle that question? Mr. Gibbs?

Mr. GIBBS. We are incredibly supportive of that comment and think there is broad support for it. If I may, I didn't get a chance to respond to a part of a question.

Mr. MANZULLO. That would be fine. Go ahead. That is fine.

Mr. GIBBS. On the definition of who is an advisor, I just have a note of caution or point of view on the scopic definition, which is namely that the actual scope and functionality between the dealer who is not a fiduciary and the advisor who is often has very useful overlap to issuers.

I just put caution that it not be purely a scopic definition and that, again, the underwriter exception is very important that it be broad so that the scope of what an underwriter covers isn't narrowed, and that we also have some concern that issuers not be limited in how they get advice.

And that one of the best ways to define who is providing advice is that it is pursuant to current MSRB regulations, someone who is under contract to provide that advice. And that if the definition had started from that point, a lot of the broader scope that has been of concern in much of the testimony today would have been, boom, addressed.

Mr. FIRESTINE. And if I could just add to the issue of appointed officials, it goes well beyond colleges and universities. You will note in my testimony that there are many regional boards. I think, for example, I serve on the D.C. Water and Sewer Authority, but there are many in this area where I think it would be difficult if those individuals were regulated to find competent people to serve on those boards, too.

Mr. DOTY. I am very frustrated that the SEC did this. Because it just delays—

Mr. MANZULLO. You can just tell them it is stupid if you think so.

Mr. DOTY. I am not going to use that sort of terminology, but I am frustrated. And like Mr. Marz, I want this regulation in place to reach the nonregulated people like me. And as I have said, I think it should include dealers as well—not in their underwriting capacity, but it should include dealers as well as unregulated people. But it should be a level playing field for everybody.

Mr. MANZULLO. Mr. Chairman, thank you. I yield back.

Mr. DOLD. The gentleman yields back. We certainly thank you for your questions. The Chair asks unanimous consent to enter into the record statements from the ACLI and the National Association of Independent Public Finance Advisers. Without objection, it is so ordered.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

Before I adjourn the hearing, I just want to thank our panel again for taking your time to be with us and sharing your expertise. I think it has certainly been beneficial.

With that, this hearing is adjourned.

[Whereupon, at 11:21 a.m., the hearing was adjourned.]

A P P E N D I X

July 20, 2012

OPENING STATEMENT
CHAIRMAN BACHUS
Subcommittee on Capital Markets and Government Sponsored Enterprises
"The Dodd-Frank Municipal Advisor Rule and H.R. 2827"
July 20, 2012

Thank you, Chairman Garrett, for convening this hearing to examine the impact of Section 975 of the Dodd-Frank Act, which governs the oversight of municipal advisors. I also want to thank Congressman Dold for introducing a bipartisan bill that would refine this provision and capture the truly unregulated who may be offering financial advice to municipalities.

Section 975 of Dodd-Frank directs the Securities and Exchange Commission to establish an effective registration and examination program for municipal financial advisors. This is an entirely worthy goal and one I support, especially as I have seen in Jefferson County, Alabama how unscrupulous municipal advisors pocketed the lucrative fees associated with the county's sewer bond offerings while ignoring the welfare of the taxpayers.

However, even though I agree with the goal of Section 975, I cannot support the SEC's proposed rules to implement it because the SEC's proposal would require thousands more to register with the SEC than Congress ever intended.

For example, the proposed rule's broad definition of "municipal financial products" combined with the failure to define the word "advice" would require thousands of bank employees who conduct routine business with municipal entities to register with the SEC.

Additionally, the proposed rule would require appointed, non-ex officio municipal board members and officials to register with the SEC. Many small towns frequently appoint, rather than elect, their municipal administrators. Similarly, boards of trustees of public universities are appointed. Forcing these individuals, who often volunteer their time and expertise, to register with the SEC would create a significant disincentive for qualified individuals to serve their communities.

Finally, the SEC's rule ignores an explicit exemption contained in Section 975 for "engineers providing engineering advice" to municipal entities.

Given these and other examples, it is unsurprising that SEC Chairman Schapiro acknowledged in an April 25, 2012 Financial Services Committee hearing that the SEC "cast the net too widely" in its proposed rule. While I take some comfort from Chairman Schapiro's acknowledgement, I do not believe Congress can just sit back and hope that the Commission gets it right the second time.

That is why I support Congressman Dold's bill, which would ensure that "non-broker-dealer financial advisors" register with the SEC without forcing thousands of others to comply with this rule.

I thank our witnesses for appearing this morning and I yield back the balance of my time.

Testimony of Robert Brooks, Ph.D., CFA
Wallace D. Malone, Jr. Endowed Chair of Financial Management
The University of Alabama
before the
United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
July 20, 2012
The Impact of the Dodd-Frank Act on Municipal Finance

Chairman Garrett, Ranking Member Waters and Members of the Committee:

Good morning. I am Robert Brooks, a finance professor at The University of Alabama. My area of academic work is financial derivatives and financial risk management, including municipal derivatives. Thank you for the privilege of participating in this event. It is an honor for me to be here.

I would like to make eight brief points regarding the impact of the Dodd-Frank Act on municipal finance. Beforehand let me offer a unique perspective on the Jefferson County, Alabama financial crisis to help understand my point of view.

Synopsis of the Jefferson County, Alabama financial devastation
Since 1998 I have used the 1997 swap transaction between Jefferson County, Alabama and J. P. Morgan to train my students on how *not* to do a swap transaction. The 1997 swap idea, promoted by Raymond James Financial, Inc., was to refinance an existing variable rate bond with a fixed rate bond and then enter a swap transaction to create a synthetic variable rate bond. The Raymond James Financial, Inc. pitch book suggested significant savings in the form of lower interest costs.

After millions of dollars of transaction costs and fees, the synthetic variable rate paid by Jefferson County was dramatically higher than the original variable rate bonds. I am not aware of any financial institution that would refinance their own variable rate to a higher synthetic variable rate and take on more risks. Raymond James Financial, Inc. brokered the swap on behalf of J. P. Morgan and Jefferson County had no independent advisor acting in a fiduciary capacity for Jefferson County. Although there were many independent advisory firms available to provide this service, Jefferson County officials did not want it.

Later relying on the advice of other financial institutions, Jefferson County officials then proceeded to enter over $5 billion notional amount of swaps tied to other failed strategies based on a heavy debt burden. Although there have been several prosecutions in Alabama, there has not been much apparent consequence to the financial institutions that facilitated this financial devastation. Remember that at the time of this activity (1997 through 2003), Jefferson County as well as financial institutions that facilitated this financial devastation were heavily regulated entities.

I would now like to offer eight brief points regarding the impact of the Dodd-Frank Act on municipal finance.

1) Regulatory burden must be reasonable
The compliance burden placed on municipal advisory firms must be reasonable and every effort should be made to avoid duplication and unintended consequences. We would not want to drive the highly ethical and skilled professionals out of this industry. For example, if a derivatives advisory firm provides quality services to a variety of entities, at this moment it is unclear under the Dodd-Frank Act whether the derivatives advisory firm would have to register with the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC) and/or the Municipal Securities Rulemaking Board (MSRB). One unintended consequence might be that other registrants, such as registered investment advisors and commodity trading advisors, would now be able to offer municipal derivatives advisory services regardless of their competency in that arena.

2) Regulatory ambiguity promotes tyranny
Ambiguous laws and regulations may result in tyrannical enforcement where particular regulators arbitrarily bring enforcement actions. Since I live in Alabama, I would like to use the local university rivalry to emphasize this important point. Suppose you encountered the following speed limit sign on an Alabama interstate, "Drive At A Reasonable Speed." This ambiguous law instantaneously creates the potential for the Alabama highway patrol to arbitrarily bring enforcement actions.

There is the potential that on Alabama's west side of the state, cars with The University of Alabama vanity tag would receive fewer speeding tickets and on the east side of the state, cars with Auburn University vanity tag would receive fewer speeding tickets. If you have a University of Tennessee vanity tag, you might think twice about driving on that Alabama interstate at all!

On the more serious side, every effort should be made to make legal compliance crystal clear, such as "Speed Limit 70." In that way, law abiding firms will have certainty regarding their compliance. The present high level of ambiguity in the Dodd-Frank Act might result in enforcement actions against innocent or unsuspecting parties. This risk is a strong deterrent for young finance professionals entering municipal finance.

3) Regulations need to improved transparency
Every International Swaps and Derivatives Association (ISDA) confirmation letter that I can recall contains explicit language related to representations, specifically non-reliance, evaluation/understanding, and status of parties. In essence, this portion of the derivatives documents state that each counterparty has made their own independent judgment or is relying on its own advisors. Most importantly, there is an explicit denial of a fiduciary relationship between the two counterparties.

In reality, often derivatives ideas emanated from financial institutions pitching the transaction. The idea was "sold" to the municipality based on some sort of convincing pitch book where benefits are emphasized and well-known risks are omitted. Due to other demands, the municipal representatives rely on and trust the financial institution. From the municipality's perspective, there is a practical fiduciary relationship.

The municipal officials trust the representations of the financial institution's professionals. Ultimately, finance is and has always been a trust business. Historically, banks often had the word "trust" in their corporate name. The solution may lie more in financial institutions re-embracing their ancient fiduciary responsibilities, rather than the rule of law attempting to place layer upon layer of complex and ambiguous regulations.

At a minimum, financial institutions should embrace transparency by clearly documenting the services they are providing, providing clear identification of conflicts of interest, written documentation of all their compensation sources and strongly recommend that municipalities find their own independent, capable advisor who is willing to act as their fiduciary.

4) Important role of municipal finance industry demand

The municipal finance industry historically has demanded transaction-driven financial consulting services. Commission hungry and ethically questionable derivatives salespeople are not the best source of ideas for creative and innovative solutions to complex municipal finance problems. It should be suspect that often the very idea promoted by a financial institution would never be done at that same financial institution. The municipal entity's leaders should demand a vibrant set of municipal advisory firms that embrace their fiduciary duty to the municipal entities they serve.

Consider the following analogy: Suppose I am experiencing heart problems (say pressure from appearing at a congressional hearing) and have the choice of two different cardiologists. Dr. Red Cuttem only receives compensation if he conducts open-heart surgery. Dr. Green Soy is paid for whatever services are provided, including her time for routine office visits. Who is more likely to provide the unbiased advice that diet and exercise will solve my heart problems?

The municipal professional associations should be at the forefront of leading a cultural change. The municipal finance advisory providers will adapt their business model to whatever their customers demand.

5) Important role of self-enforcement

Like most communities, self-enforcement is an excellent deterrent for criminals. Remember I live in Alabama where hunting is very popular, giving pause to many would-be intruders. For example, if a large financial institution is found to have ravaged a specific municipality through malicious derivatives advice, then through industry-wide self-enforcement, that particular financial institution should find itself unable to create demand for their services. This loss of market share, coupled with severe regulatory enforcement action, would provide a healthy deterrent. The municipal industry, perhaps through its professional organizations, should provide a clear message to those institutions that instigate harm on municipalities.

6) If regulators frame financial risk management, then systemic risk increases

Many concepts within financial risk management are not well defined and hence, not well understood. Remember that finance is a social science, not a physical science. For example, market participants' beliefs about how certain financial instruments should be valued will influence their value.

Most finance practitioners have a general understanding of "hedging," but it is surprisingly difficult to pin down. For example, the 1997 Jefferson County swap transaction was promoted as a hedge of interest rate risk. Within a year, the 1997 swap transaction was terminated. If entering the swap was hedging, what was terminating the swap?

As another example, consider two general approaches to interest rate risk management, view-driven and needs-driven. Interestingly, financial institutions seek to balance out their interest rate risk using asset liability management techniques (needs-driven). These financial institutions do not attempt to manage interest rate risk by guessing where rates are going. Surprisingly, these same financial institutions will place a derivatives salesperson on a plane to pitch a view-driven derivatives transaction on an unsuspecting municipal official. It seems reasonable that the financial institution pitching the derivatives deal should be willing to do it themselves if they were facing similar circumstances. Clearly, there are a wide variety of ways to frame the interest rate risk management task.

Therefore, if regulators are allowed to forcefully frame the context of financial risk management, then systemic risk is actually increased and not decreased.

7) Hedging is ill-defined due to the lack of benchmarks specified in advance
The Dodd-Frank Act documents the following permitted activity for banks. "Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings" are permitted and hence referred to as a bona fide hedge in the Act.

Most banking entities have hundreds of positions with exposures to numerous market risks. These same firms have multiple stakeholders with different goals and objectives. There is no requirement in the Act, or for that matter in any other related regulations, for firm-wide financial performance benchmarks to be clearly defined in advance. Therefore, almost any financial derivatives transaction arguably can be deemed a "bona fide hedge." All one must do is identify some existing exposure in the firm with the appropriate empirical correlation and voila, a derivatives transaction is a "bona fide hedge." But from almost any ethical framework, such as the CFA Institute's Code of Ethics and Standards of Practice, many financial derivatives transactions today do not pass as a "bona fide hedge;" they would be deemed deceitful and in bad faith. Because finance falls in the social sciences, ethics is primary and analysis is accidental. Unfortunately, for many in finance – especially academic finance, analysis is primary and ethics is accidental.

For students of the human condition, it would come as no surprise that corporate as well as municipal executives today assert that the activities of their entities are "bona fide hedges" in the Dodd-Frank Act sense. If these executives, however, were asked to justify their hedging transactions to their aging parents, they would struggle to do so without blushing. Without any preconceived and clearly stated financial risk management benchmarks, whether a municipal entity is on course or not is meaningless.

8) Municipal finance career need to be attractive
It is a given that the regulatory environment governs how municipal finance is practiced day-to-day, but what may not be obvious is that it also influences who chooses to enter this vocation. If the municipal finance landscape resembles a prison environment, then we should not be surprised that many highly ethical, competent, creative professionals opt for an alternative finance profession. If the financial landscape instead encourages innovation and creativity where self-enforcement is reliable, then we will observe more highly ethical professionals opting for the municipal finance profession.

In summary, the municipal finance industry historically has been regarded as dubious by many finance professionals, there appears to be little downside risk for criminals and no real representation of interests of the tax paying public. We must resolve the numerous existing structural problems in municipal finance so there exists an attractive environment for highly ethical, innovative and creative professionals to enter and serve the municipal finance industry. There are many young professionals today interested in this type of public service. We should create an attractive environment for them to flourish.

TESTIMONY OF ROBERT DOTY ON H.R. 2827

Before the

**UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES**

**SUBCOMMITTEE ON CAPITAL MARKETS
AND GOVERNMENT SPONSORED ENTERPRISES**

Hearing on The Impact of the Dodd-Frank Act on Municipal Finance (July 20, 2012)

Chairman Garrett, Representative Waters and Members of the Committee, thank you for inviting me to testify before you this morning regarding H.R. 2827 and its potential impacts upon local governments across the nation. I am Robert Doty, a municipal advisor. For almost 40 years, I have dedicated my career to working with local governments both as a dealer representative and a nondealer financial advisor, as well as a bond counsel and issuer counsel in municipal securities transactions. I have advised and assisted many local governments benefiting from the issuance of billions of dollars of municipal securities in two dozen states. I have worked closely with hundreds of state and local officials and believe firmly that I understand well their interests and needs.

With all due respect, I wish to raise certain very serious concerns that you may wish to consider and regarding which you may wish to exercise substantial care before proceeding with this legislation.

I urge you to recognize the municipal market's self-regulatory structure through the Municipal Securities Rulemaking Board as the best way to resolve issues and to define appropriate municipal advisory roles and relationships by means of negotiation among representatives of the varying market sectors. The members and staff of the MSRB are experienced market professionals and business people who understand very well how to balance costs against benefits of self-regulatory decisions. (Incidentally, there are more than twice as many dealer representatives on the MSRB as there are nondealer advisors.)

In particular, based upon my almost 40 years of experience in working directly with local governments, I am concerned that local governments will lose extremely important protections from which they benefit through municipal advisor regulation, if H.R. 2827 is passed by Congress in its present form.

The municipal advisory role is intended to be a role of providing competent and unbiased advice to local governments, and tied very closely to that, includes a fiduciary duty to the issuer. This is quite different and distinct from serving in the adverse roles of an underwriter, a bond trader or a financial product marketer. That is one important reason why separate and robust municipal advisor regulation is needed.

Please understand that I consider many representatives of both dealers and nondealer advisors to be honorable and competent providers of municipal advice. I also recognize, however, that there are financial advisors both affiliated with and separate from dealers who lack the necessary competence and, in a few cases, who may be conflicted in providing advice, sometimes unfortunately without disclosure. Some dealers and nondealer municipal advisors sometimes do not always act with their clients' best interests at heart. The forthcoming rulemaking by the MSRB in this area will go a long way to address these issues and develop a truly level playing field in which the same rules apply to both dealer and nondealer advisors.

Without that true level playing field, I fear that local governments and investors will suffer substantial harm. That can, in turn, create substantial economic damage to local economies and detract from the prospects for national economic recovery.

To understand better the nature of the municipal advisory role, you may wish to hear about some of the municipal advisory services that I have provided to clients over the years. Because I have not accepted contingent fees for almost 20 years, I have been able to advise my clients in an unbiased manner NOT to issue bonds and NOT to incur more debt when doing so would have been unwise. My services have included—

- Assisting local government clients in obtaining efficient, economical financing
- Assisting local government clients in structuring sound securities issues
- Assisting local government clients in employing strong, competent underwriters, bond counsel and other finance professionals
- Assisting local government clients in avoiding unwise covenants and structures that would have placed the clients at great risk
- Warning a local government client NOT to attempt an acquisition of a private utility company, when doing so would have been costly and highly risky
- Assisting a small local government client, newly formed, but with sound revenues, to obtain financing
- Warning another local government client NOT to borrow for a project the client could not afford, even when a lender was willing to loan funds
- Assisting several clients in working out defaulted bond issues that were causing the clients substantial economic harm, when earlier advisors had failed to warn about significant risks

I am convinced that effective municipal market self-regulation—with informed and full participation by dealer and nondealer advisors, issuers and investors—is the best way to define appropriate relationships, to resolve issues and to implement appropriate rules.

Because not all municipal advisors—whether dealers or nondealers—are not fully competent and some fail to recognize, or even ignore, conflicts of interest and their local government clients' best interests, I believe that testing the advisors' competence and knowledge of their advisory responsibilities, as well as providing continuing education and professional standards to guide them, are extremely crucial for the protection of state and local governments.

The Municipal Securities Rulemaking Board has been very constructive in its approach, currently waiting for the SEC's finalization of the municipal advisor definition prior to acting with rulemaking over municipal advisors. Once the SEC acts, the true level playing field can be implemented appropriately thorough the MSRB's market self-regulation.

Who are the people who are protected by this municipal market self-regulation?

The SEC estimated that there are 50,000 municipal issuers in the country. The Municipal Securities Rulemaking Board estimated 80,000. Joseph Mysak, a noted municipal expert with Bloomberg, indicated based upon Census data that there are more than 90,000 municipal entities in the country, although not all of them are issuers of municipal securities. The officials of the vast majority of the issuers are not sophisticated regarding municipal finance.

So, the MSRB's rules will help protect numerous governmental entities. Ensuring that bonds issued by these jurisdictions is done properly, with competent assistance from financial advisors, and at the lowest yield possible, also helps reduce the burden to taxpayers. One central goal is to minimize state and local property taxes and local utility rates, for example.

The officials of these local governments —hundreds of thousands of officials charged with protecting the public interest—are elected or appointed on the basis of their commitment to the public interest including, among other things, concerns such as the following—

- Reducing taxes
- Eliminating budgetary deficits and balancing budgets
- Spending taxpayers' money wisely
- Efficient and economical management and operation
- Reducing utility rates
- Filling pot holes
- Fighting crime
- Controlling traffic
- Collecting garbage
- Preventing and fighting fires
- Improving education for our children, and
- Many more local agendas determined at the local level by local citizens

With few exceptions, they definitely are NOT municipal finance experts. After all, municipal finance is a highly arcane area of expertise that very few people understand.

These public officials are mayors, city council and county commission members, school superintendents and school board members, managers and board members of local agencies and special districts. They are in every congressional district. They are Republicans and Democrats. They are people of all political persuasions. They are people upon whom you rely for advice and support. Overwhelmingly, they believe that, when they perform their roles appropriately—through due diligence looking into experience and backgrounds of the municipal advisors they employ—they have performed their roles as they should and have served the public interest.

Many members of this honorable body have served as local officials and have made decisions such as those outlined above. The SEC's proposed municipal advisor definition, erroneously in my opinion, included appointed members of state and local governing boards. The inclusion of these board members, really gets it wrong.

Those officials place great trust in the municipal advisors they select. Not being municipal finance experts they make decisions to employ, and therefore must rely, out of sheer necessity, upon the municipal advisors they choose. They are led to believe and expect competent, disinterested and honest advice solely in the local governments' best interests. This is why a fiduciary standard on advisors is so essential.

The fiduciary duty of municipal advisors—including the duty to exercise due care, the duty of loyalty to avoid conflicts of interest, and the duty to provide sound advice solely in the local governments' best interests—is absolutely essential to the municipal advisory function.

For emphasis, unlike underwriting and trading relationships, the fiduciary duty is the very heart of a municipal advisor's role and responsibilities.

Without the fiduciary duty, tens of thousands of local governments, hundreds of thousands of local officials, and hundreds of millions of local taxpayers and ratepayers would be at significant risk—as they have been in the past—of snake oil sales pitches made in disguise by municipal advisors posing falsely as honorable advisory professionals serving solely in the local governments' best interests.

When these people are unmasked—usually when their unsound advice already has caused harm to local communities—most of the time it is far too expensive for local governments and local officials, with severely limited budgets, to spend literally millions of dollars in seeking to correct these wrongs. Almost always, local governments, realizing the substantial costs and risks of litigation, make the difficult and painful choice simply to move on and to lick their wounds. The losses, of course, are borne unfortunately by local taxpayers and ratepayers.

Such mistakes harm not only local citizens and taxpayers. The mistakes also harm investors when unwise securities offerings are brought to market. Two-thirds of municipal securities are owned by retail investors directly or through mutual funds.

These investors can lose their savings when unsound, poorly-considered municipal securities are released into the market. Municipal advisors have the responsibility of warning local governments against such transactions, and at the same time, also protecting investors.

It is far better for these wrongs simply to be prevented through competency testing and continuing education of all municipal advisors and through reasonable professional standards. It is far better, through market self-regulation on a true level playing field, to weed out those municipal advisors—both dealers and nondealers—who would abuse their relationships of trust with local governments in your congressional districts and other districts across the nation.

I urge you to give full, careful consideration to all of the implications of H.R. 2827. I urge you to support the municipal securities market's self-regulatory mechanism. I urge you to support a true level playing field in which all municipal advisors serve solely the best interests of tens of thousands of local government clients in your districts and across the nation. I urge you to consider carefully the potential for harm that would result for local governments, taxpayers, ratepayers, investors, and the public interest by failing to recognize the essential character of the municipal advisors' fiduciary duty and by restricting the municipal market's self-regulation of all municipal advisors.

Thank you again for your courtesy and for inviting me.

TESTIMONY
TIMOTHY FIRESTINE
CHIEF ADMINISTRATIVE OFFICER
MONTGOMERY COUNTY, MARYLAND
on behalf of the
Government Finance Officers Association

Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
U.S. House of Representatives
July 20, 2012

Chairman Garrett, Ranking Member Waters and Members of the Subcommittee, thank you for the opportunity to speak before you this morning. I am Tim Firestine, Chief Administrative Officer of Montgomery County, Maryland. I currently also serve as President-Elect of the Government Finance Officers Association (GFOA), which represents over 17,000 public finance professionals across the United States who are responsible for the budgeting, accounting, investing and debt management for their cities, counties, special districts and states. Prior to becoming CAO in Montgomery County, I was the County's Finance Director for 15 years and also served for 12 years in various management positions in the County's Office of Management and Budget. I began my public finance career in Allegheny County, Pennsylvania. The subject of this hearing is important to me as a public finance professional and to our entire membership.

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* includes a number of provisions that are of interest to state and local governments. As you will read in my testimony, these include - and the GFOA supports - parity between the credit ratings assigned to municipal and corporate securities and regulating the derivatives market. We also support the federal regulation of municipal advisors, which is the focus of today's hearing.

Regulation of Municipal Advisors

Under Title IX of the *Dodd Frank Act*, advisors to state and local governments will be regulated for the first time under the authority of the Municipal Securities Rulemaking Board (MSRB). The GFOA supports such regulation and believes its purpose should be to ensure that state and local governments have access to qualified advisors who meet appropriate business standard requirements, are independent of conflicts of interest, have a federal fiduciary standard to their state and local government clients (e.g. issuers of municipal securities), and provide suitable financial solutions for each particular government's situation.

The past two years have demonstrated that defining what constitutes a municipal advisor is not a simple task. This is most clearly shown by the Securities and Exchange Commission's (SEC) inability to finalize the definition of municipal advisor. The SEC's proposed municipal advisor definition from 19 months ago is problematic on a number of fronts. The legislation being discussed today, H.R. 2827, would remedy some of these problems, but it also would cause additional problems for state and local governments.

The proposed legislation would solve a major issue by exempting from the proposed municipal advisor definition any state or local government employee or members of its governing board. Unfortunately, the SEC's proposed definition of municipal advisor exempts only elected board members and employees serving their own entity. It does not exclude <u>appointed</u> members of state and local governing boards where borrowing and investment issues are discussed. Captured by such a definition, tens of thousands of Americans appointed to a state or local government board, usually without pay, could be considered to be municipal advisors. This would have a chilling effect on both the willingness of citizens to serve on these boards and the day-to-day governance of the governmental entity. It is worth noting that numerous state and local government associations[1], individual governments, those in the public service, and many within

[1] Organizations opposing the inclusion of appointed members of state and local governing boards in the municipal advisory definition include – the National Governors Association, National Association of Counties, National League of Cities, U.S. Conference of Mayors, International City/County Management Association, National Association of Local Housing Finance Agencies, Council of Infrastructure Authorities, National Association of State Auditors, Comptrollers and Treasurers, and Council of Infrastructure Authorities.

Congress wrote to the SEC opposing this part of the proposed definition.

Under the proposed municipal advisor definition, I personally could be classified as a municipal advisor. In my position as CAO of Montgomery County, I serve on the board of the DC Water and Sewer Authority and chair its Finance and Budget Committee. We discuss numerous issues, including financial transactions involving both debt issuance and investments. It boggles my mind that my service as a member of a body that determines what should be done to meet constituents' needs – including the hiring of finance professionals –could make me a regulated municipal advisor.

It is unclear why the SEC proposed such a broad definition, although we have heard of vague and unsubstantiated references to concerns about appointed board members acting improperly as a member of a governmental board. We ask that the SEC focus on any specific problems it believes exists and develop appropriate rules that would rid the market of bad actors if it can be shown that current laws and regulations are inadequate. The SEC's definition of municipal advisor uses a sledgehammer when a chisel is needed and has created great uncertainty to those who serve in the public sector and to the municipal securities market. The SEC needs to act quickly to fully and clearly exempt appointed members of state and local governing boards from the definition of municipal advisors.

As I mentioned, H.R. 2827, attempts to remedy this problem and does so by specifying the definition does not include "any elected or appointed member of a governing body of a municipal entity with respect to such member's role on the governing body." We applaud this section of the legislation but find other exemptions to the municipal advisor definition within the bill problematic, as discussed below.

The SEC's proposed definition covers municipal advisors who are currently unregulated, but as drafted, it could interfere with the types of discussions that could and *should* occur between dealers and issuers. Conversely, the legislation introduced by Congressman Dold could open the door too widely and allow for such sweeping exemptions that some professionals could avoid appropriate regulations.

Certainly, independent financial advisors should be regulated and included in the municipal advisor definition. Dealers, when having disclosed to the issuer their intention to serve as underwriter and not financial advisor on a particular financing, should not be unnecessarily constrained by the municipal advisor definition when discussing with issuers such matters as market dynamics and various financing options. However, dealers that choose to occasionally work as financial advisors should have additional obligation through regulations imposed on them when they serve a government as a financial advisor even though they may already be regulated as a dealer. The existence of a fiduciary obligation to the issuer is a distinct difference between the financial advisor and the underwriter functions. Merely because a dealer is regulated as an underwriter should not suggest that it is able to fulfill the unique fiduciary responsibilities that come with being a financial advisor. H.R. 2827 indicates that if a professional is already regulated, no further regulations should apply. Such a broad exclusion from the definition could mean that a professional who is both a dealer and a financial advisor might never have to meet important and necessary regulatory criteria because he or she already is regulated as a dealer.

Another area that needs careful consideration is how to craft the municipal advisor definition to ensure that when the issuer does not engage the services of a financial advisor in a negotiated sale (an action discouraged by GFOA Best Practices), the dealer does not present itself as a trusted advisor to the issuer, but instead maintains that it has an arm's length relationship with the issuer. Current MSRB rules state that a dealer cannot deter the issuer from hiring an advisor and the dealer must state that it does not have a fiduciary duty to the issuer. However, both the SEC's definition and the subsequent MSRB rules need to carefully consider that when there is a dealer and not a financial advisor in a transaction, the dealer must not violate these rules and specifically does not present itself as having the issuer's best interest preeminent versus the dealer's self interest. Especially in this circumstance, H.R. 2827 may allow the exemptions to the municipal advisor definition to be so wide that adequate protections may not be in place for the issuer.

H.R. 2827 also tries to remedy concerns that the SEC's definition of municipal advisors includes professionals working for financial institutions. The proposed solution in the legislation would appropriately excludes professionals within financial institutions such as trustees and professionals who provide traditional brokerage and banking services, but again, the exemption in the legislation may be too broad and exclude financial institution professionals who provide advisory services that should be covered by the municipal advisor definition and subsequent rules.

We also have concerns that H.R. 2827 would eliminate the federal fiduciary standard. We strongly disagree with this approach, as a uniform and federal standard should be in place, in order to ensure that all advisors adhere to the same standard. A fiduciary standard is very important to the issuer community due to varied state standards and a municipal securities market that transcends state lines. A federal standard is essential in order to help protect issuers and eliminate any confusion about what standards apply to their hired municipal advisors.

Changes to MSRB Mission

The MSRB's mission has changed to include the protection of municipal entities in addition to its longstanding mission to protect investors. The GFOA has stated in writing to the MSRB that we believe its mission is to include the needs and perspective of issuers when it is developing regulations for broker/dealers and municipal advisors. We do not believe that the MSRB should act in a direct manner that does or appears to advise, regulate, or impose itself on issuers of municipal securities outside of what is necessary and beneficial to help issuers use and understand the repository for disclosure documents – the Electronic Municipal Market Access (EMMA) system and the various rules over dealers and financial advisors that ultimately affect issuers and their transactions.

Since 2010, the MSRB has completed a considerable amount of rulemaking that has been beneficial to the marketplace and issuers of municipal securities. While most of the rulemaking for municipal advisors is pending SEC action, the MSRB has drafted appropriate rulemaking for advisors to ensure that some type of framework is in place over these professionals. We believe the MSRB is well poised to propose, finalize and implement these rules, once the SEC completes its work on the municipal advisor definition.

The MSRB has altered three rules related to dealers that are particularly helpful to issuers of municipal securities -- Rules G-23 (on dealer-financial advisors), G-17 (on fair dealing), and G-34 (on information about new issues).

Rule G-23. Prior to recent changes to Rule G-23, a dealer firm that also provides financial advisory services, could, with disclosure to the issuer, resign from being the financial advisor in a transaction in order to turn around and become the underwriter of these bonds. GFOA has long advised our members to clearly and cleanly separate the duties of the financial advisor and the underwriter so as to avoid the clear and absolute conflict of interest that arises when a financial advisor recommends a negotiated sale, and then resigns in order to underwrite the bonds in that negotiated sale. The MSRB rightly changed Rule G-23 so that a financial advisor is prohibited from resigning and becoming the underwriter in that transaction. We believe this has been very beneficial in protecting issuers of municipal securities by ensuring that the financial advisor on a transaction carries out its fiduciary duty to the issuer by recommending, among other things, the appropriate method of sale (competitive vs. negotiated) for a financing, free from the absolute conflict of interest that arises when the dealer-affiliated financial advisor has the option of resigning as advisor in order to underwrite bonds in a negotiated sale.

Rule G-17. Next month, due to MSRB's action on its Rule G-17, underwriters will have to make certain disclosures to an issuer. These include stating in writing that the underwriter does not have a fiduciary responsibility to the issuer, disallowing the underwriter from deterring the issuer from hiring a financial advisor, disclosing any third party arrangements or possible conflicts of interest and disclosing risks associated with the proposed transaction.

We support this interpretation of the Rule and believe the implementation of these new standards next month will help better define the role of the underwriter to the issuer and, along with similar and forthcoming rulemaking pertaining to financial advisors, provide issuers and the marketplace with a better understanding of the roles of finance professionals.

Not-Reoffered ("NRO") Designation. The MSRB has approved a rule that is awaiting SEC action that would disallow the use of the term "not reoffered (NRO)" in conjunction with the reporting of bond sale results, unless such designation is accompanied with the price or yield at which such bonds were sold. The NRO designation has often been used by dealers when referring to maturities of a bond issue that have been pre-sold or are otherwise not available to the general public. We have responded to the MSRB that the NRO designation without corresponding yield information masks the price at which these bonds are sold and therefore renders the information useless to the marketplace for developing pricing comparables. This practice has been especially common in competitively-sold bond issues, where true market pricing is most likely to be revealed. Issuers and investors benefit from improved pricing transparency.

Consideration of Suitability Standards. Another issue that underlies much of the above rulemaking and the bond and derivatives markets in general is whether there should be a suitability standard regarding the types of financial products that can be pitched and sold to state and local governments by all types of professionals, including dealers and financial advisors. While financial advisors have a fiduciary responsibility to municipal entities that would be stronger than a suitability requirement when advising governments, consideration of additional rulemaking addressing this issue may be needed. This is especially the case with dealers and should be reiterated with financial advisors, especially those who advise obligated persons rather than municipal entities. While developing a suitability standard may be difficult to appropriately define and administer – it could go a long way in ensuring that governments use financial products and issue bonds in a manner that best fits their jurisdiction.

Changes to MSRB Board Composition

We support the changes made to the composition of the MSRB that make it a public-member majority board. The MSRB acted swiftly in 2010 to effect this requirement, and the larger number of board members – 21 – has helped the MSRB respond to various congressional mandates with a broader perspective. We are especially pleased that the Board has three members from the issuer community, when the *Act* calls only for "at least one member" from our sector.

Regulating the Derivatives Market

The GFOA has longstanding recommendations and policy urging members to use caution when deciding whether to use derivatives, either as investment vehicles or in conjunction with bond transactions. We fully support the *Dodd Frank Act*'s regulation of this market under Title VII. Regulations to protect governments, especially small governments, will be in place this fall. Mandatory use of a swap advisor with a fiduciary duty to the issuer is especially helpful to governments and authorities who use these products. Had such regulations been in place earlier, many governments may have avoided being sold products that were not suitable for their jurisdictions. The GFOA has developed an Advisory on the Use of Derivatives and Establishing a Derivatives Policy, along with a Derivatives Checklist to aid issuers in determining the questions they should be asking in conjunction with such transactions. These documents are currently being updated to reflect the new regulations, but the bottom line remains the same – without specific policy related to the use of derivatives, and a solid and ongoing understanding, education, and monitoring by finance staff about these types of structures, they should be avoided by state and local governments. We believe relatively few governments have the internal policy direction and staff expertise to make derivatives suitable for their entity. As events of the past few years have demonstrated, many issuers, and for that matter, broker-dealers and advisors, have failed to appropriately understand and anticipate the risks associated with these products with devastating financial consequences to state and local governments in many cases.

While we are pleased that the SEC and CFTC published final swaps regulations last week, this market will need continuous monitoring, to ensure that the regulations live up to their intentions and work appropriately in this sector. We would also like to see more detailed information about specific derivative transactions in the public domain, and hope that the MSRB's authority to develop information systems can address this issue in the future.

Another topic that should be reviewed is how the recently uncovered LIBOR scandal is affecting outstanding swaps, and how the apparent manipulation of that index cost governments that were involved in various interest rate swaps where the index was used, as well as other financial products.

Credit Rating Agency Changes

The *Dodd-Frank Act* imposes numerous new rules affecting credit rating agencies that will help state and local governments, both with respect to ratings on the issuer's own securities as well as ratings on securities in which state and local governments invest their surplus cash. As was discussed before this Committee in May of 2009, developing uniform meaning for all credit ratings, regardless of the sector, is imperative to help investors understand the creditworthiness of various products. As has been demonstrated over and over again by the rating agencies, municipal debt is of far better credit quality than similarly-rated corporate debt, yet for years, it has been, as a class, underrated. The default level among municipal securities has historically been a fraction of that of corporate bonds. However, many rating agencies have applied a more rigorous scale to municipal securities than to corporates. Such lower ratings have likely cost governments, especially small governments, as lower ratings translate directly into higher borrowing costs. We also believe the intent of the *Act* was to base the criteria used for ratings on the default risk and ultimate recovery experience for specific types of credits and market sectors. Such criteria only reinforce the fact that the muni sector, especially governmental debt, has historically proven to be safer than the corporate sector. SEC rulemaking is pending on this matter, and we encourage it to follow through on these changes to rating practices and methodologies.

There are many other regulations that have been and will be imposed on rating agencies that will be beneficial to state and local governments and global investment and issuer communities alike. However, we are troubled by certain business practices that some of the rating agencies have undertaken since the passage of the *Act*. This includes a significant increase in the cost of ratings and the development of new rating contracts that are unnecessarily confusing at best and seriously disadvantageous to issuers at worst. We are especially concerned that some of these contracts attempt to deflect responsibilities of the rating agencies through indemnification clauses that result in the direct opposite effect that the *Act* intended – that the rating agencies accept greater responsibility and provide more transparency about their methodologies and business practices.

An area not addressed in the *Dodd Frank Act*, but certainly in the spirit of the law, is to have the credit rating agencies automatically post ratings directly to the MSRB's Electronic Municipal Market Access (EMMA) system – the repository for all municipal securities. A direct feed of ratings in real-time that can be freely accessed would be beneficial to the entire market and the public at large. The MSRB has been working to have the credit rating agencies send data feeds to EMMA, but one agency, Moody's Investors Service, has yet to participate in this initiative.

This is especially troubling, because we have recently seen many municipal bonds downgraded, not because of their own credit, but because the rating was tied to a bank or bond insurer that was downgraded; however Moody's did not directly alert the bond issuer of the downgrade. Such business practices are troubling and confusing. One remedy is to have credit ratings sent to EMMA so that the most up-to-date information is publically available. With this change, issuers should be relieved of their material event obligation to report rating changes to EMMA, since issuers are often the last to be made aware of changes to their bond ratings.

We also applaud the possibility of additional competition that may be forthcoming in our sector. Additional players in this arena who have met requirements specified by the SEC will likely enhance the work of all rating agencies and benefit those who must obtain ratings in order to sell their securities.

Volcker Rule

GFOA, along with numerous other state and local government organizations, has responded to rulemaking related to the Volcker Rule and its impact on municipal securities. Specifically, we urged the agencies to exempt from the Rule all municipal securities, rather than only the obligations of states and political subdivisions, as proposed.

The proposed rule appropriately seeks to exempt municipal securities from the section related to banking institutions engaging in certain proprietary trading activities in keeping with the statute and Congress' intent. However, the proposed rule included a too narrow definition of municipal obligations that would be excluded from the Rule. We urged the regulators to use the municipal securities definition in the *1934 Securities Exchange Act*, as they've done in the past, so that there is not a bifurcation in the market, and perhaps a limit on the types of bonds that banks can underwrite and sell.

Other Issues

Money Market Mutual Funds

The GFOA and numerous other state and local government associations have expressed opposition to the SEC's interest to develop unnecessary and likely disruptive changes to rules governing money market mutual funds. This is especially true with proposals to change the stable net asset value to a floating net asset value, which would be harmful to local and state governments. State and local governments use MMMFs to handle their cash management and investment responsibilities, and the funds are the largest purchaser of short term municipal securities. Needless and harmful changes to fund rules could cause significant disruption in our ability to safely manage our citizen's money and could increase borrowing costs if these large purchasers reduce their buying power of municipals.

CUSIP Numbers

The GFOA has been working with other market participants to shed light on the troubling and opaque practices used by the CUSIP Service Bureau and the companies that own or administer this system - American Bankers Association, Standard and Poor's and McGraw Hill Companies. Specifically, in order to allow for the municipal market (or any securities market) to run smoothly, and as required by numerous SEC rules, an identifying number of the security is needed in order for the bonds to be sold, as well to enable investors to easily find information about these bonds, and for the issuer of the bonds to submit required financial information to applicable repositories. In essence, this identifying system acts like a public utility, and walks like a public utility but is NOT a public utility - it is part of a private enterprise that is apparently outside of SEC jurisdiction. This is especially disconcerting when certain parameters are imposed on both issuer and investors of securities in their ability to use CUSIP numbers in their work to learn more about a security, either through public systems such as EMMA, or other research vehicles.

We recommend that this Committee, as well as the SEC, look at opportunities to provide needed regulatory oversight over the identifying system of securities. In particular, full access to CUSIP numbers should be available to the marketplace and easy to access electronically. These changes would help ensure that the market functions as seamlessly and efficiently as possible. Of note, European Union financial regulators have recently investigated the practices of counterparty entities to the CUSIP Service Bureau and have settled charges to curb anti-competitive practices.

Conclusion

The *Dodd Frank Act* contains many important provisions for the municipal market. This is especially true regarding the regulation of municipal advisors, which is the focus of today's hearing. In order to implement these important changes to the municipal market, the SEC should act appropriately to complete its work on a municipal advisor definition that exempts appointed state and local governing board members from the definition, while retaining a federal fiduciary standard that should be imposed on those providing advice to state and local governments, whether they are independent financial advisors or financial advisors affiliated with a dealer firm. The municipal advisor definition should be completed by the SEC as soon as possible so that the MSRB can develop essential rulemaking that will provide a proper and fair regulatory landscape for the advisors and dealers that serve state and local governments.

Unfortunately, the legislation discussed today, while seeking to provide appropriate exemptions in order to make the SEC's proposed definition workable, goes too far in its quest to do so. If the legislation were enacted as introduced, many state and local governments would find themselves unprotected from some problematic market practices due to the lack of regulations over various professionals, as well as not being able to depend on an important federal fiduciary standard for municipal advisors.

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Testimony of the Honorable James E. Geringer,
Board Chair of Association of Governing Boards of Universities and Colleges

House Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Entities
July 20, 2012

Chairman Garrett, Ranking Member Waters, Members of the Subcommittee on Capital Markets and Government Sponsored Entities, I thank you for granting me the privilege of testifying before your Subcommittee in this timely and important hearing regarding H.R. 2827, which clarifies provisions of the Dodd-Frank Act concerning the registration of municipal advisors.

I am testifying today in my position as Chair of the Board of Directors of the Association of Governing Boards of Universities and Colleges. AGB is the only national association that serves the interests and needs of all academic governing boards, boards of institutionally related foundations, and campus CEOs and other senior-level campus administrators on issues related to higher education governance and leadership. We serve more than 40,000 individuals at over 1,900 colleges, universities, and affiliated organizations.

I also serve as Chair of the Board of Trustees of Western Governors University, and have had the honor of serving two terms as Governor of the State of Wyoming.

H.R. 2827 addresses an issue that has been of great concern to colleges and universities over the last year and a half, relating to the implementation of certain provisions of the Dodd-Frank Act relating to persons acting as municipal advisors. The Dodd-Frank Act created a new regulatory regime for municipal advisors, including a requirement that municipal advisors register with the SEC. In January of 2011, the SEC issued proposed rules defining the term "municipal advisor" for purposes of these provisions.

Unlike corporate directors, trustees of public and non-profit colleges and universities are not compensated for their board service. They are unpaid volunteers who devote their time, experience, and talent to serving the public interest. In total, approximately 50,000 men and women serve as volunteer trustees of public and private colleges and universities in the United States. An additional

45,000 volunteers serve on the boards of institutionally related foundations, which are private charitable organizations that raise and manage funds for public colleges and universities. The service of these individuals protects institutional independence and autonomy and is essential to effective governance.

Although we commend the SEC for clarifying in the proposed rules that elected board members of municipal entities, including elected trustees of public colleges and universities, will not be required to register as municipal advisors, we have been concerned that the proposed definition of "municipal advisor" could be construed to include appointed trustees of public universities, trustees of private non-profit universities, and trustees of institutionally related foundations, who are not explicitly exempted from the registration requirement. Trustees who discuss municipal financial products at board meetings and authorize institutional participation in municipal securities offerings could mistakenly be viewed as providing "advice" (a term neither the Dodd-Frank Act nor the proposed rule defines) to an "obligated person" and thus become subject to regulation as municipal advisors.

We support the goals of the Dodd-Frank Act and the SEC of ensuring appropriate oversight of advisors to municipal entities and conduit borrowers. However, it is imperative that the quality of institutional governance not be compromised by counterproductive, needless, burdensome, and off-putting regulation of trustees acting in their fiduciary capacity. Such a result would conflict with Congressional intent and interfere with trustees' fiduciary responsibilities. It would also significantly hinder the ability of public and private colleges and universities to attract and retain highly qualified trustees with financial expertise, to the detriment of these institutions, their students and faculty, and the nation.

To regulate trustees as municipal advisors is to misunderstand profoundly their role and legal status. The board of trustees of a university is a governing body, not an advisor. The difference between, on the one hand, the ultimate governing body of a higher education institution and, on the other hand, an advisor to the institution, is both legally straight-forward and basic to long-standing, vital principles of institutional governance in higher education.

Regulation of trustees' conduct under the Dodd-Frank Act would be not only contrary to legislative intent and inconsistent with longstanding SEC interpretation of "advisor," it is also unnecessary. The conduct of trustees of colleges, universities, and institutionally related foundations is already subject to a multitude of laws. Trustees must comply with state not-for-profit corporation law; fiduciary duty laws; institutional policies, such as policies on conflicts of interest; state education law; the standards of accreditation bodies; IRS rules for tax-exempt organizations; and multiple other regulatory regimes.

Whereas municipal advisory firms may be able to offset the burdens of regulatory compliance, volunteer trustees are differently situated. Institutions of higher education are challenged to attract the most highly qualified volunteers to invest uncompensated time in trusteeship. A perception that trustees may be deemed municipal advisors would exacerbate this challenge, particularly with regard to recruitment of persons with financial expertise.

For reasons I've described, AGB supports the provisions in H.R. 2827 clarifying that certain persons acting in their capacity as elected or appointed members of a governing body are not municipal advisors. We note, however, that the language in H.R. 2827 only exempts "any elected or appointed members of a governing body of a municipal entity, with respect to such member's role on the governing body," but does not similarly exempt elected or appointed members of a governing body of an "obligated person," such as trustees of private non-profit universities, and trustees of institutionally related foundations. We recognize that the exemption was likely drafted this way in light of the fact that the Bill also narrows the general definition of "municipal advisor" to only include persons providing advice to a municipal entity, and not to an obligated person. If, however, the Bill were to be amended to include in the definition of "municipal advisor" persons providing advice to obligated persons (as under current law), we would urge the Committee to expand the exemption to include elected or appointed members of a governing body of an obligated person, with respect to such member's role on the governing body, in order to ensure that the exemption covers trustees of private non-profit universities, and trustees of institutionally related foundations. In that event we also would urge that the exemption for employees of municipal entities be similarly expanded to include employees of obligated persons, to ensure that staff members of private non-profit universities, and of institutionally related foundations, would not be considered municipal advisors.

Again, I thank you for this opportunity.

James E. Geringer

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Statement of Kenneth Gibbs
Member, Board of Directors and Chair, Municipal Securities Division
Securities Industry and Financial Markets Association

Before the

Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

July 20, 2012

Hearing on the Impact of the Dodd Frank Act on Municipal Finance

Chairman Garrett, Ranking Member Waters and other subcommittee members, thank you for the opportunity to be here. I am Kenneth Gibbs and I am President of the Municipal Securities Group at Jefferies & Company, Inc. in New York. I appear here today not on behalf of Jefferies, but in my capacity as a member of the Board of Directors of the Securities Industry and Financial Markets Association ("SIFMA"),[1] where I also serve as Chairman of the Municipal Securities Division. I am pleased to be here to discuss the impact of the Dodd-Frank Act ("DFA") on municipal finance.

The $3.7 trillion municipal bond market is a vital sector of our capital markets. Our federal system of government places a number of responsibilities on states and localities, including education, development of public infrastructure and promoting health care and affordable housing, among others. Many of these functions require significant long-term capital investments, and much of that capital is raised in the municipal bond market. One of the extraordinary features of the market is the breadth of issuers that are able to access the marker efficiently. Issuers from the largest states and cities to the smallest towns and school districts are able to access capital with maturities of up to 30 years or more at low fixed rates, and with a diversity and flexibility of structure and credit. This degree of market access is unheard of in other countries or even in other sectors of our own financial markets. The median size of a municipal bond issuance last year was under $6 million, and thousands of issuers sold bonds of less than $10 million. At the same time, the municipal market continues to be one of the safest available to

[1] The Securities Industry and Financial Markets Association brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

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investors, with a default rate well under 0.5 percent, while uniquely respecting the sovereignty of its issuing constituents.

It is important for the municipal market to function soundly and efficiently in order to protect investors and other market participants and to ensure the lowest possible cost of financing for state and local governments and their citizens. Efficient and effective regulation is a vital component of a sound market.

The DFA includes a number of provisions that are having, or will have, an effect on municipal finance, the municipal bond market, and municipal market participants. Now that it has been two years since the enactment of the DFA, it is appropriate for Congress to review the effects and consequences of the Act. In that regard, we commend Chairman Garrett for calling this important hearing and we are grateful to participate.

My testimony today will focus on four general areas:

- Section 975 of the DFA relating to the registration and regulation of municipal advisors ("MA"), including H.R. 2827, legislation to amend those provisions;
- The "Volcker Rule" as it relates to municipal securities;
- Section 978 of the DFA related to funding for the Government Accounting Standards Board; and
- Provisions of Title VII of the DFA in the context of swaps used in relation to municipal finance.

Regulation of Municipal Advisors

Section 975 of the DFA includes provisions that establish a regulatory framework for MAs. MAs are consultants that provide advice to state and local governments with regard to financial transactions such as bond issuance, use of derivatives, investment of bond proceeds and other activities. Before the DFA, MAs who were not broker-dealers were wholly unregulated, one of the last unregulated parties active in the financial markets. Regulations that apply to broker-dealers and municipal securities dealers who provide MA services, on the other hand, have encompassed MA activities for many years. It was appropriate, therefore, for Congress to bring MAs under the regulatory umbrella. SIFMA supported and actively advocated for the inclusion of MA regulation in the DFA because we believe it is important to level the regulatory treatment for dealer and non-dealer MAs and to ensure that non-dealer MAs are appropriately policed with respect to competency, conflicts of interest, interaction with bond issuers and other areas.

In its work leading to the enactment of the DFA, the Financial Services Committee examined the issue of unregulated municipal advisors. In a hearing on May 21, 2009, the Committee heard testimony on H.R. 2550 (111th Congress), the Municipal Advisers Regulation Act. At the hearing, both then-Chairman Frank and Ranking Member Bachus expressed support, at least conceptually, for regulating MAs, with then-Ranking Member Bachus stating "Mr. Chairman, of the measures that are the subject of today's hearing, the legislation, your legislation to regulate unregulated municipal financial advisors is one that I could accept, with some changes. We are in agreement with the basic premise that the SEC should require individuals who advise municipalities to register as investment advisors."[2] Key elements of H.R. 2550 were eventually incorporated into the DFA.

On September 1, 2010, after the enactment of the DFA, the Securities and Exchange Commission ("SEC") published an interim final temporary rule to implement the MA registration requirements of Section 975 of the Act.[3] The interim final temporary rule is much broader in scope than what was intended by Congress in enacting the MA provisions of the DFA and goes far beyond simply regulating previously unregulated advisors. It also left many key questions unanswered in terms of what constitutes "advice" provided to municipal entities, the scope of the fiduciary duty of MAs, and the scope of the "investment strategies" provision of the DFA, among others. Because the SEC has not yet completed work on the final municipal advisor registration rule, key elements of the interim final temporary rule are still in force.

One illustration of the breadth of the interim final temporary rule in relation to Congress' original intent with regard to MA regulation is the number of entities that have registered with the SEC as MAs since the rule took effect. In testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs in March 2009—before the enactment of the DFA and before the SEC's temporary municipal advisor registration rule—the Municipal Securities Rulemaking Board ("MSRB") indicated that 260 non-dealer municipal financial advisors participated in at least one municipal securities transaction in 2008.[4] As of July 17, 2012, under the SEC's temporary municipal advisor registration rule, 1,132 firms have registered as municipal advisors.[5] One reason the number of registered municipal advisors so far exceeds the number of advisory firms actually active in the market is that the SEC's temporary rule is so much broader, and farther-reaching than Congress considered in 2009 when the DFA was being conceived.

On December 20, 2010, the SEC published a proposed rule on Registration of Municipal Advisors[6] (the "Proposed Final Rule"). The SEC's Proposed Final Rule goes much farther than Congress intended when the DFA was being drafted. Rather than being limited to previously unregulated municipal advisors, the Proposed Final Rule would encompass in the definition of MA a wide breadth of entities and activities that are outside Congress' intent, outside the scope of the statute, and outside the scope of what

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[2] Committee on Financial Services, U.S. House of Representatives, One Hundred Eleventh Congress, hearing transcript on "Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance," May 21, 2009, Serial No. 111-37, page 3.

[3] Securities and Exchange Commission, "Temporary Registration of Municipal Advisors," Release No. 34-62824, September 1, 2010.

[4] Testimony of Ronald A. Stack, Chair, Municipal Securities Rulemaking Board, before the Committee on Banking, Housing and Urban Affairs, United States Senate, March 26, 2009, page 27.

[5] U.S. Securities and Exchange Commission, "Municipal Advisor Temporary Registration Forms Received," at https://tts.sec.gov/MATR/. The MSRB also has a parallel registration rule. It is interesting to note that not all firms that registered as MAs registered with both the SEC and the MSRB.

[6] U.S. Securities and Exchange Commission, "Registration of Municipal Advisors," Release No. 34-63576, December 20, 2010.

market participants generally understand to be MA activities. Some examples of activities and entities covered by the SEC's Proposed Final Rule but outside the scope of the statute include, among others:

- Certain appointed, unpaid members of issuer governing bodies, such as, for example, volunteer members of a local government board or commission;[7]
- Banks providing "traditional banking services" or "investment advisory services" such as deposit accounts or trustee services;[8]
- Investment advisors or others who provide advice regarding the investment of not only the proceeds of municipal securities, as provided in the statute, but virtually any public funds such as pension funds or Section 529 college savings plans;[9] and
- Broker-dealers or banks serving as or seeking business as underwriters with respect to many services and functions typically performed by investment bankers.[10]

SIFMA provided extensive comments to the SEC on its Proposed Final Rule, which outline numerous other areas where the proposal goes beyond congressional intent or statutory authority.[11] The SEC has received over 1,000 comment letters on the Proposed Final Rule, many from state or local officials, with the overwhelming majority opposed to all or part of the proposal.

Focusing on the role of underwriters and the bond issuance process, Congress in the DFA explicitly excluded from the definition of MA "a broker, dealer, or municipal securities dealer serving as an underwriter." However, the SEC's proposed implementation of that exclusion is too narrow and would be detrimental for bond issuers. In a "negotiated" bond sale, a bond issuer typically selects one or more dealer firms to serve as underwriter, often through a competitive "request for proposals" process. Sometimes before the selection process begins, investment bankers present ideas or suggestions that may or may not result in transactions. After the selection, the selected underwriter typically provides many services to the issuer leading up to the pricing and sale of bonds and sometimes after the closing. These services can include help with structuring, sizing or timing the capital program or sale, performing calculations or analysis regarding the credit terms or other features, interaction with rating agencies, pre-marketing the bonds to investors and other functions. Underwriters are generally not compensated separately for these services, but rather these services are part of the overall process of underwriting bonds in a negotiated sale. Congress would not have included an underwriter exclusion to the MA definition in the statute if their intention was to cover investment banking activities such as recommendations and suggestions on the structure, timing, terms and other similar matters in the definition of MA.

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[7] *Id.*, page 41.
[8] *Id.*, page 42.
[9] *Id.*, page 26.
[10] *Id.*, page 31.
[11] Letter from Leslie M. Norwood, SIFMA, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, February 22, 2011.

The SEC has interpreted the underwriter exclusion from the MA definition narrowly to encompass only the function of price negotiation and purchase of the bonds by the underwriters. The proposed interpretation of the underwriter exclusion would not cover all the other services and functions provided by an underwriter in the context of serving a negotiated issuer. If adopted as proposed, the Proposed Final Rule would limit the ability of state and local governments and other municipal securities issuers to obtain services necessary for, and typically provided in the context of, the bond issuance process. The result would be higher costs and poorer transaction execution for state and local borrowers.

Moreover, treating the value-added services typically provided by underwriters in the context of negotiated underwritings as MA services is incompatible with the role of underwriter for two reasons. First, the DFA imposes a fiduciary duty on MAs with respect to their issuer clients. While a fiduciary relationship is acceptable for MAs—indeed, MAs have had a fiduciary duty to their issuer clients under state laws for many years—it is at odds with the role underwriters play in bond sales. Underwriters are arm's-length counterparties, particularly in the context of the price negotiation and sale. A "buyer-seller," counterparty relationship is fundamentally incompatible with the role of a fiduciary, which generally entails a duty of loyalty and the requirement to place the needs of the client first. Underwriters, on the other hand, serve as a bridge between issuers and investors and must consider the needs and requirements of both parties when negotiating the price of a new bond issue.

The SEC's Proposed Final Rule would also potentially result in a confusing array of standards of conduct, which is particularly troubling in the context of a rule designed to clarify roles. A firm hired as an underwriter on a negotiated transaction would declare itself an underwriter under MRSB rules. That dealer could bear a fiduciary duty to the issuer with respect to advice leading up to the pricing. That fiduciary duty would end when the price negotiation began.

Most important, the SEC has not provided any justification or basis for treating investment banking services as MA activity. Nowhere in the legislative history associated with the MA provisions in the DFA is there any indication that Congress intended the definition of MA to include investment banking services. Indeed, Congress explicitly excluded underwriters from the definition. The SEC has simply interpreted that exclusion inappropriately narrowly.

Now that the DFA is two years old and the SEC's Proposed Final Rule has been out for 19 months, we are hopeful that the SEC will act quickly to finalize the rule in a manner that respects Congress' intent and the scope of the SEC's authority under the statute.

H.R. 2827

On August 26, 2011 Rep. Bob Dold (IL-10) introduced H.R. 2827, legislation which would amend the DFA to ensure that the statutory definition of MA incontrovertibly reflects Congress' original intent. The bill now has 35 cosponsors, both Republicans and Democrats. The bill includes several tailored, sensible amendments to the DFA that would prevent any regulatory misinterpretation:

- The bill would specify that a party is a MA when that party "is formally engaged, in writing and for compensation, by a municipal entity to provide advice." This is the generally accepted means of defining the advisory role among market participants, and MSRB rules mandate a written agreement for advisory services.
- The bill would exclude from the definition of MA parties that either are already excluded under the statute currently or were already regulated before the DFA, such as broker-dealers and banks, among others.
- The bill would exclude from the MA definition "any elected or appointed member of a governing body of a municipal entity."
- The bill would clarify the definition of "investment strategy" so that it encompasses only the proceeds of bond issues, as Congress intended, and would exclude from the definition of MA certain activities and services such as serving as custodian or acting as a broker without providing advice, again consistent with Congressional intent.
- The bill would ensure that certain communications between a municipal entity and a pooled investment fund would not cause the fund's manager to be treated as a MA; and

In short, H.R. 2827 would clarify language in Section 975 of the DFA to ensure, as Congress intended, that the statute encompasses those activities performed by municipal financial advisors who were unregulated before the DFA was enacted, and excludes those parties and activities that are already heavily regulated. SIFMA supports H.R. 2827 and urges Congress to act on the bill quickly.

The Volcker Rule and Municipal Finance

Section 619 of the DFA creates a new Section 13 of the Bank Holding Company Act ("BHCA"), known as the "Volcker Rule," generally prohibiting any banking institution from engaging in certain proprietary trading activities or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with "hedge funds" and "private equity funds". Federal regulators including the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission (the "Agencies") have since issued proposed rules to implement Section 619[12] (collectively, the "Volcker Rule Proposal"). SIFMA has raised significant, substantive concerns with various aspects of the Volcker Rule Proposal, especially with the "market making" exception to the rule. Our general comments are embodied in a letter we filed together with other associations on February 13, 2012.[13] In addition, SIFMA's Municipal Securities Division filed a letter focusing on the effects of the

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[12] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011) and Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds (proposed Jan. 13, 2012).
[13] SIFMA, The Clearing House Association, The Financial Services Roundtable and the American Bankers Association, "Comment Letter on the Notice of Proposed Rulemaking Implementing the Volcker Rule – Proprietary Trading," February 13, 2012.

Volcker Rule Proposal on municipal finance.[14] Those statements describe our views on the Volcker Rule Proposal in considerable detail.

In sum, with respect to the effects of the Proposed Volcker Rule on municipal finance, there are two general areas of concern. The first relates to a provision in Section 13(d)(1)(A) of the BHCA that exempts from Volcker Rule restrictions trading in, among others, "obligations of any State or of any political subdivision thereof." Congress included this exemption in the DFA in recognition that municipal securities are extraordinarily safe investments and generally do not pose substantial risks for banks and in order to help maintain a liquid and active market for municipal securities, thereby keeping state and local financing costs low. Unfortunately, the Agencies have proposed to interpret "obligations of any State or of any political subdivision thereof" too narrowly.[15] Congress clearly intended to exclude the full municipal securities market from Volcker Rule restrictions, and the proposed rule violates that intent. The proposed interpretation would also artificially bifurcate the market by excluding bonds issues directly by state and local governments but not excluding bonds issued by state and local agencies and authorities.

The MSRB estimates, based on information from Thompson Reuters, that in calendar year 2011, 41.4 percent of municipal securities issued were sold by agencies and authorities[16] and would not be excluded from Volcker Rule restrictions. Many of these agency and authority bonds are for vital government functions such as water and sewer systems, public power systems, hospitals and universities and similar types of facilities. In many cases, bonds issued by agencies and authorities are no riskier, and may even be less risky, than bonds issued directly by governments. In other circumstances, the choice of whether to issue bonds by a government directly or through an agency or authority is based on convention or local statute and has no bearing on credit or other risk or on how the bonds are considered by the market.

Excluding one segment of the municipal market from Volcker Rule restrictions while subjecting another to the restrictions would cause substantial confusion. It is not always obvious from looking quickly at a security whether it is issued by a government directly or by an agency, and there is a significant "grey area" between government and agency bonds. We are concerned that some banks, rather than facing the risk of violating the Volcker Rule by trading restricted municipal securities, would simply avoid the municipal market altogether, reducing liquidity. Moreover, banks are one of the few remaining sources of institutional demand in the municipal market, and discouraging their participation in the market could result in higher borrowing costs for municipal bond issuers. Most important, we believe Congress intended for municipal securities generally to be excluded from Volcker Rule restrictions. Hence, we

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[14] Letter from David L. Cohen, SIFMA, to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission on "Comments on Volcker Rule Proposed Regulations," February 13, 2012.

[15] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, page 68,878, footnote 165.

[16] Letter from the Municipal Securities Rulemaking Board Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, January 31, 2012, page 2.

have urged the Agencies to exclude from Volcker Rule treatment all municipal securities as defined in Section 3(a)(29) of the Securities Exchange Act of 1934.

Our second area of concern relates to the treatment of tender option bonds ("TOBs") under the Proposed Volcker Rule. TOBs are financial products created by dealers or other market participants by depositing fixed-rate municipal securities in a pass-through trust and selling interests in the trust to investors. The TOB interests generally are floating-rate securities and are supported by a feature where investors can sell their interests to a remarketing agent or bank at face value periodically. Creating a TOB also generally results in creating a residual class of TOB interests that is almost always retained by the bank or dealer that sponsored the transaction. The residual interests generally entail no more risk to the holder than the underlying securities themselves. TOBs' features combined often make them compliant with SEC Rule 2a-7 and eligible for investment by money market mutual funds. They also satisfy investor demand for short-term-like municipal investments, which tend to be in short supply in the market, particularly in current conditions. TOBs actually give investors greater security than the underlying bonds because they are fully supported by liquidity facilities. Moreover, TOBs provide a source of demand for municipal securities that has the effect of lowering borrowing costs for borrowers. TOB volume can run into the hundreds of billions of dollars, depending on market conditions, and can represent an important source of demand. In addition, TOBs are an important means for bond dealers to finance their inventories, which improves liquidity for investors. The TOB market has existed for over 20 years, and TOBs generally performed well during the financial crisis.

The Proposed Volcker Rule would prohibit bank investment in "covered funds." As proposed by the Agencies, covered funds would functionally include TOB trusts, effectively prohibiting banks from holding TOB residual interests. The proposed rule would effectively bar banks from establishing TOB programs. Those hurt by this prohibition would include state and local government borrowers, which would lose an important source of demand for their securities, and money market mutual funds and their shareholders, which would lose an important source of low-risk, high-quality investments. We have urged the Agencies to treat TOB interests in the same manner as municipal securities and exclude TOBs from Volcker Rule restrictions.

Funding for the Governmental Accounting Standards Board

Section 978 of the DFA authorizes the SEC to require the Financial Industry Regulatory Authority ("FINRA") to collect a fee from its members to fund the Governmental Accounting Standards Board ("GASB"). On May 11, 2011 the SEC issued such a direction to FINRA[17] and on February 23, 2012 the SEC approved FINRA's Rule to implement a new tax on dealers to fund GASB[18] ("FINRA Rule"). Unfortunately, the new fee structure effectively represents a "blank check" for GASB, which is particularly troubling given that there is little oversight over GASB's budget or activities.

[17] U.S. Securities and Exchange Commission, "Order Directing Funding for the Governmental Accounting Standards Board," Notice No. 33-9206, May 11, 2011.
[18] Financial Industry Regulatory Authority, "GASB Accounting Support Fee," Regulatory Notice 12-15, March 2012.

GASB is the accounting standards setter for state and local governments and government agencies and authorities. Unlike the Financial Accounting Standards Board ("FASB"), however, GASB does not fall under the oversight of the SEC, and there is no statutory or regulatory requirement that governments comply with GASB Generally Accepted Accounting Principles ("GAAP"). According to the U.S. Government Accountability Office ("GAO"), over the period 2006-2009, GASB was funded through a combination of "voluntary financial contributions" and the sales of subscriptions and publications by FASB and GASB.[19] Since the adoption of the FINRA Rule, dealers have received invoices for the funding of GASB, and the tax on dealers has become GASB's principal funding source. The fee imposed by the FINRA Rule is based on each FINRA dealer's municipal securities trading activity as reported to the MSRB's Real-time Trade Reporting System ("RTRS"). While we support and appreciate the role that GASB plays in the market, we feel strongly that requiring FINRA's dealer members to fund GASB is wholly inappropriate:

- The fee imposed by the FINRA Rule is an unfair tax on broker-dealers and municipal bond investors who should not be mandated to subsidize the entire expense of financially supporting GASB.
- There are many other end users of GASB's accounting and financial reporting standards, such as non-debt issuing municipalities, financial advisors, banks, bank dealers, insurance companies, rating agencies, mutual funds, legislative/governmental staff, and taxpayer organizations that get a "free ride" under FINRA's fee.
- The fee imposed by the FINRA Rule provides virtually unlimited funding for GASB. GASB simply tells FINRA how much funding they need for a given year, and FINRA structures the tax to raise that much revenue. There is no direct or indirect independent budget oversight – in effect "taxation without representation" with no incentive for transparency or fiscal discipline.
- Many municipal bond obligors are not GASB reporting entities. Many municipal bond obligors are private non-profit corporations, and thus are subject to the rules of FASB, not GASB. The fee imposed by the FINRA Rule makes no distinction between bonds issued by GASB obligors, bonds issued by FASB obligors and bonds with obligors who follow neither set of standards. It would be inappropriate to tax transactions in bonds issued by obligors that do not utilize GASB standards.
- The fee imposed by the FINRA Rule unfairly burdens certain dealers and is not allocated equitably. Any accounting support fee should be business model/operationally neutral, and FINRA's fee is not. Not all trades reportable to the RTRS involve customers. Additionally, under certain circumstances multiple assessments are charged from a single purchase and sale. Supply chains that involve multiple dealer trades are more heavily impacted. Finally, the municipal securities transactions of bank dealers'–who comprise a significant portion of trading activity–are not covered by FINRA's proposal, as they are not FINRA members.

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[19] U.S. Government Accountability Office, "Dodd-Frank Wall Street Reform Act: Role of the Governmental Accounting Standards Board in the Municipal Securities Markets and Its Past Funding," Briefing for offices of the Committee on Banking, Housing, and Urban Affairs, United States Senate, and the Committee on Financial Services, House of Representatives, January 12 and 13, 2011, page 29.

The breadth of our concerns regarding the FINRA Rule is outlined in our comment letter on the proposed rule filed with the SEC.[20]

While we recognize that the SEC and FINRA are bound by the restrictions of the statute, we maintain that imposing a fee on dealers to fund GASB is inappropriate. FASB is funded primary by fees paid by corporate securities issuers. This approach is appropriate since corporations and other businesses are the primary users and beneficiaries of FASB's work. We urge Congress to consider a statutory amendment to the GASB funding provision of the DFA to change the way GASB is funded, perhaps based on the FASB model, as well as to impose independent oversight of GASB's budget.

Derivatives Regulation and Municipal Finance

Title VII of the DFA includes substantial new regulations relating to products and participants in the market for over-the-counter swaps. These new regulations cover a wide range of products and activities, many of which have implications for state and local governments that use swaps as a component of their financing and swap dealers who transact with states and localities. SIFMA's Municipal Securities Division has focused mostly on two areas, the business conduct standards in Section 731 of the DFA and the mandatory clearing requirements in Section 723.

Section 731, related to business conduct standards, imposes significant new regulatory obligations on swap dealers and major swap participants with respect to swap counterparties. These obligations are heightened in the context of swaps executed with "special entities," a term that includes state and local governments. Swap dealers are now required to make disclosures to counterparties covering such areas as, among others, information about the material risks and characteristics of the swap and any material incentives or conflicts of interest that the swap dealer or major swap participant may have in connection with the swap. The obligations for swap dealers executing swaps with special entities under Title VII are even stricter and include, among others, a requirement that the swap dealer has a reasonable basis to believe that the counterparty has an independent representative that has sufficient knowledge to evaluate the transaction and risks; is independent of the swap dealer; and undertakes a duty to act in the best interests of the counterparty it represents as well as other factors. If the swap dealer is also serving as an "advisor" to a special entity counterparty, that dealer has a duty to act in the best interests of the counterparty, among other requirements.

On February 17, 2012, the Commodity Futures Trading Commission ("CFTC") published the final rules implementing the business conduct standards in Section 731.[21] SIFMA had urged the CFTC in general to construct the business conduct rules in such a way as to preserve the ability of state and local governments to execute swap contracts when appropriate. We have some concerns with the final

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[20] Letter from David L. Cohen, SIFMA, to Elizabeth M. Murphy, SEC on SEC File No. SR-FINRA-2011-073: Notice of Filing of Proposed Rule Change Relating to Establishing a Governmental Accounting Standards Board Accounting Support Fee, January 30, 2012.

[21] Commodity Futures Trading Commission, "Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties," *Federal Register*, Vol. 77, No. 33, February 17, 2012, page 9734.

business conduct rule, which we continue to raise with the CFTC. However, the rule in general, while imposing substantial new obligations on swap dealers, will allow state and local governments to continue to execute swaps when warranted.

Section 723 of the DFA generally requires swaps to be cleared through derivatives clearing organizations ("DCOs"), a function that will require counterparties to a swap contract to maintain margin accounts at the DCOs. Rules and practices governing states and localities effectively prohibit governments from tying up public funds in margin accounts. Fortunately, the DFA includes a provision exempting "end users" from the mandatory clearing requirements if the end user is not a financial entity, is using swaps to hedge or mitigate commercial risk, and notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps. Earlier this month the CFTC finalized its rules implementing the end user clearing exception.[22] We had urged the CFTC during the consideration of the rule to ensure that states and localities are not "financial entities" and that interest rate and other risks generally hedged and managed by states and localities would be included in "commercial risk." The final rule appears to have addressed those concerns.

While the new regulations governing municipal swaps are not unmanageable, a key question is whether swap dealers and state and local governments will bear the additional regulatory obligations required to continue to use derivative products. We continue to monitor other areas of swap regulation, such as the anticipated rules governing margin requirements for uncleared swaps, to ensure that the new rules preserve the ability of state and local governments to execute swaps when appropriate.

Conclusion

The DFA includes a number of provisions which will have a significant effect on the municipal securities market. Among these are regulation of municipal advisors, the Volcker Rule, a new funding scheme for GASB, and regulation of over-the-counter swaps. We have been working with regulators to help ensure that implementation of these elements of the DFA will allow the market to function smoothly while ensuring that Congress' intent is fully realized. However, important issues remain unresolved:

- The SEC has not yet finalized its municipal advisor registration rule, and the proposed final rule includes numerous provisions that would go against congressional intent and statutory authority, including issues related to the underwriter exclusion. H.R. 2827 would help address these issues by clarifying key provisions in the statute.
- The Volcker Rule, as proposed by the financial regulatory agencies, would take too narrow an approach to the municipal securities exclusion in the statute and, if adopted as proposed, would bifurcate the market and increase borrowing costs for states and localities with no benefit to bank safety and soundness.

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[22] Commodity Futures Trading Commission, "End-User Exception to the Clearing Requirement for Swaps," available at www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_11_EndUser/ssLINK/federalregister071012.

- The GASB funding provision in the DFA is misguided because it imposes the funding obligation on FINRA-member dealers, parties that have little to do with GASB's activities. The FINRA rule related to GASB funding provision is also unfairly implemented because it fails to tax non-FINRA dealers and is inappropriately based on trading activity. It also provides a virtually unlimited funding source for GASB with little oversight over its budget or activities. We urge Congress to revisit the entire approach to GASB funding.

SIFMA looks forward to continuing to work with regulators and Congress to help ensure that the reforms embodied in the DFA are fairly and efficiently implemented. Thank you for the opportunity to present our views.

Testimony of Christine Keck
Director of Government Relations
Energy Systems Group

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services, U.S. House of Representatives

July 20, 2012

Chairman Garrett, Ranking Member Waters, members of the Subcommittee, my name is Christine Keck and I am an executive with Energy Systems Group (ESG). On behalf of ESG and the energy services (ESCO) industry, I appreciate the opportunity to share my views on H.R. 2827 and the rulemaking underway at the Securities and Exchange Commission (SEC) regarding the registration of municipal advisors.

Energy Systems Group applauds Congressman Dold for the introduction of his important legislation. We support the objective of the bill, which attempts to exclude those who provide engineering advice from registration as a municipal advisor – including energy services companies. This was the original intent of Congress when it passed the Wall Street Reform and Protection Act.

Congressman Dold's legislation is a positive step in addressing the impact to the ESCO industry of the proposed rule under consideration at the SEC. The rule proposed recognizes that engineers provide advice as part of engineering services, but we believe it too narrowly defines the advice that the engineering exclusion would cover. As I will explain in my testimony today, the "advice" and "services" ESCOs provide to customers are inexorably linked and, as such, should be excluded from the definition of municipal advisory activity.

We are seeking a rule that properly interprets the term "engineering advice," recognizes the inexorable link between the continuum of services ESCOs provide and, in the final analysis, appropriately excludes ESCOs from the requirement to register as municipal advisors.

Energy Systems Group

Energy Systems Group is an award-winning and nationally-accredited energy services company that develops innovative and self-funding energy and infrastructure solutions for a broad range of customers, of which municipalities account for a substantial amount of contracted work. ESG is wholly-owned by Vectren Corporation, an energy services provider serving more than 1 million customers in Indiana and Ohio based in Evansville, Indiana.

Founded in 1994, ESG has implemented over $1.3 billion in projects for more than 300 customers throughout the United States and U.S. Virgin Islands. ESG is headquartered in Newburgh, Indiana and operates through local offices in the Midwest, Mid-Atlantic, Southeast and Southwest United States. ESG is licensed to do business in 39 states, the U.S. Virgin Islands and Puerto Rico.

ESG has completed or implemented approximately $250 million of energy and infrastructure improvements for municipalities. On average, municipal work accounts for nearly 25 percent of ESG's annual business portfolio. This is not inconsistent with the rest of the industry, where other ESCOs also undertake a significant amount of municipal work.

Energy Systems Group is accredited by the National Association of Energy Service Companies (NAESCO) as an energy services provider. During the last twenty years, NAESCO-member companies have delivered thousands of Guaranteed Energy Savings Projects across the US and in a number of other countries. NAESCO member projects have produced:

- $40B in projects paid from savings
- $50B in savings – guaranteed and verified
- 380,000 person-years of direct employment
- $25 billion of infrastructure improvements in public facilities
- 420 million tons of CO_2 savings at no additional cost

ESG's comprehensive offering, which is typical of NAESCO member ESCOs, includes facility-wide audits, energy and facility project development, engineering and design services, implementation, operations and maintenance services and measurement and verification of savings.

Through our core business of performance contracting and extensive network of utility partnerships, ESG provides innovative solutions for the modernization of buildings and energy infrastructures in the government, education, healthcare and commercial sectors. ESG also designs, builds and operates waste-to-energy facilities and cogeneration plants and offers a full range of renewable energy technology solutions such as solar, wind and geothermal.

ESG has developed a particular expertise and success in developing energy conservation projects for municipal governments. Through performance contracting, ESG assists local governments in overcoming major barriers that often prevent the implementation of infrastructure and energy saving improvements. Performance contracting is a turnkey service through which comprehensive energy efficiency, renewable energy and distributed generation measures are made possible and often is accompanied with guarantees that the savings produced by a project will be sufficient to finance the full cost of the project.

Energy Services Companies

The energy services industry serves a vital role to its customers by providing energy solutions that furnish low-cost, state-of-the-art power and energy efficiency services. Public sector entities, including municipalities, look to ESCOs to address their energy maintenance and infrastructure needs through projects that generate sufficient energy and cost savings, allowing for further investments to be made in clean energy and other engineering projects.

Typically, an energy services company will review a customer's current energy sources and uses and then will propose engineering solutions designed to reduce the customer's energy costs and upgrade the physical infrastructure. If the proposal is accepted, the ESCO will build and install the energy project. Providing these services requires ESCOs to maintain expertise in both managerial and technical aspects of the engineering projects.

ESCOs provide prospective customers general information and educational material about potential energy services projects. Potential customers need this information to make a qualified judgment as to the viability and workability of the proposed project. In general, this "engineering advice" often includes:

- Preparation of energy audits, engineering diagrams, and technical reports;
- Cash flow analysis of projected savings;
- General information on available funding options and various government and utility financial incentive programs available to assist in the implementation of the project; and
- Information on potential funding sources, for which ESCOs are not compensated.

The world of energy services is complex and evolving rapidly – both in terms of the many types of projects that may be undertaken and the various financial incentive programs available to assist in the implementation of those projects. The information I have outlined often is provided during the course of deliberations about the specifics of a project. It simply is impossible to disentangle information about engineering (the different processes and technologies available to save energy) from the cost of that engineering, the savings that engineering can provide and the options for financing that engineering.

Registration of Municipal Advisors with the Securities and Exchange Commission

The statutory definition of municipal advisor, as included in Section 975 of Dodd-Frank, specifically excludes "engineers providing engineering advice." We believe the intent of Congress was clear in that engineering services, by their nature, involve the provision of project-related economic information and, therefore, "engineers providing engineering advice" should be excluded from registering as municipal advisors.

However, the SEC's proposed rule and accompanying comments effectively would place outside of the statutory exclusion the majority of situations in which engineering firms, including energy services companies, work with local governments to develop and implement energy savings and other projects. The SEC has stipulated in its proposal that cash-flow modeling or the provision of information and education relating to municipal financial products, even if incidental to the provision of engineering advice, would be deemed municipal advisory activities.

Cash-flow modeling and feasibility studies, which include a contemplation of financing – municipal or otherwise – are inexorably linked in the continuum of engineering services. Absent the ability of ESCOs to discuss the costs, savings and financing options of a potential energy project, the discussion of engineering itself essentially is useless to a customer.

Adoption of the proposed SEC rule would threaten the very nature of the ESCO industry and impede significantly our ability to undertake municipal projects that save taxpayer dollars, reduce energy usage and create jobs. In addition, it would place ESCOs – unnecessarily and contrary to the intent of Congress – under the regulatory framework of a financial services regulator, which has little or no understanding of the predominant engineering activities and services offered by an energy services company.

The Dold bill seeks to remove ESCOs from entanglement in a registration regime that was unintended and would be unnecessarily burdensome. At a time when governments at all levels are seeking greater energy efficiency and innovative cost-savings measures, our public policy should help facilitate the very projects ESCOs undertake with municipalities – not hinder them.

Our industry has engaged in constructive dialogue with the SEC and we appreciate the commission's willingness to consider the unique and complex nature of municipal energy services projects. We will continue to educate the SEC about our business practices and encourage the Commission to adopt a final rule that clearly exempts ESCOs from registration and regulation requirements that apply to municipal advisors.

Conclusion

Mr. Chairman, in conclusion I would like to thank you and the entire Subcommittee for the opportunity to provide my views here today. The outcome of the proposed rule and the exclusion from registration by ESCOs as municipal advisors is critical to the vibrancy of the energy services industry and our ability to assist municipalities in their endeavor to achieve lower-cost and more efficient energy.

I am willing to take any questions the committee may have.

July 20, 2012

Testimony of

Albert C. Kelly, Jr.

On behalf of the

American Bankers Association

before the

Subcommittee on Capital Markets and Government Sponsored Enterprises

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July 20, 2012

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee, my name is Albert C. Kelly, Jr., Chairman and Chief Executive Officer, SpiritBank, Bristow, Oklahoma. I am also the chairman of the American Bankers Association. ABA represents banks of all sizes and charters and is the voice of the nation's $14 trillion banking industry and its two million employees.

I appreciate the subcommittee taking the time to review an important new rule that may soon be issued by the Securities and Exchange Commission (SEC) requiring registration of companies that provide advisory services to municipalities.

ABA strongly believes that Section 975 of the Dodd-Frank Act (Dodd-Frank) was not intended to cover banks. Instead, it established a regulatory scheme for ***unregulated entities*** providing advice to municipalities with respect to the municipal financial products defined by Congress, e.g., municipal derivatives, guaranteed investment contracts, or investment strategies which include plans or programs for the investment of the proceeds of municipal securities.

However, the SEC has proposed rules that interpret the scope of the "municipal financial products" in Section 975 far beyond the securities activities of state and local governments to reach all "funds held by or on behalf of a municipal entity." This would mean that giving advice about traditional bank products such as deposits and loans could trigger registration as municipal advisors by most banks and each of their employees who may give "advice" to local governmental bodies such as schools, libraries, hospitals, etc.

Let me give a simple example of the unintended consequences that the proposed rule, if finalized, would bring about. The term "advice" is not defined in the SEC's proposal. Thus, we do not know whether a suggestion by a teller that the local librarian may wish to consider an interest-bearing account, rather than a checking account, would mean that the teller would have to be registered as a municipal advisor.

Registration would overlay onto the existing comprehensive bank regulatory scheme an entirely new securities-based regulatory scheme with enforcement by the SEC. The consequences would be severe. In addition to subjecting banks to wholly unwarranted and duplicative regulation and examination, which would cause banks to incur significant costs, local community banks might simply stop taking municipal deposits.

This means that local governments may have to go outside their communities—particularly in small towns, such as in my state of Oklahoma—for something as simple as a bank account. Thus, rather than protecting municipalities, such a rule would raise costs and make it more difficult to find basic financial services from their local banks.

ABA's members provide a full range of products and services to state and local governmental bodies including deposit accounts, cash management, loans, credit facilities, employee benefit, trust, advisory services, custody, securities lending, liquidity facilities for debt programs, servicing municipal debt programs, securities processing and agency services, and other capital market services. In addition, many bank employees serve their communities through appointments to or volunteering for local boards and commissions in capacities which may include providing advice with respect to municipal financial products. ***Under the SEC's proposal, these employees would be rewarded for their voluntary services to their communities by being required to register as municipal advisors in their individual capacity.***

ABA fully supports legislation (H.R. 2827) introduced by Representative Robert Dold (R-IL) that would clarify what constitutes a municipal advisor and would remove financial institutions from the proposed ill-defined definition. In the absence of this legislation we would strongly urge this Committee, as you are doing today, to conduct oversight of the SEC as it goes through the process of issuing a final rule. Such oversight would assure the results do not impose unnecessary costs and unintended consequences.

In my testimony today, I would like to focus on three key issues:

- The proposed rule goes beyond statutory intent.
- The final rule should avoid unnecessary regulatory duplication.
- Small communities would have reduced access to basic banking services under the current proposed rule.

I will discuss these items in detail below.

I. The Proposed Rule Goes Beyond Statutory Intent

ABA strongly believes banks were not intended to be covered by the provisions in Section 975. This sentiment is shared by members of Congress, including Congressman Kenny Marchant, former Vice-Chair of the Financial Institutions Subcommittee, who wrote to the SEC stating that the proposed rule goes beyond statutory intent. It seemed from the outset that the SEC agreed the focus would be narrow, as well. Martha Haines (the former head of the SEC's Office of Municipal Securities) had stated in a 2009 hearing before the rulemaking began that the focus would be on the 260 non-broker-dealer advisors. Congressman Bachus, Chairman of the full Financial Services Committee, reminded the SEC of that statement in a letter he wrote in 2009.

Aside from the letters and the hearing record, there are several points that illustrate that the focus of municipal advisor regulation should not be on regulated banks. First, Section 975 is an amendment to the Securities Exchange Act of 1934, which is intended to regulate transactions in the U.S. securities markets and the conduct of participants in those markets. In the Gramm-Leach-Bliley Act, Congress determined that banks should be able to continue to engage in traditional bank activities, already comprehensively regulated under the federal banking laws, without registering with the SEC as broker-dealers and subjecting themselves to the supervisory, examination and recordkeeping regime applicable to securities brokers and dealers. Indeed, Congress codified that determination in Section 3(a)(4)(B)(i)–(x) of the Exchange Act[1] by providing an express exemption from broker-dealer registration for a bank that effects transactions in identified banking products or other enumerated activities, including deposit-taking and lending, sweep accounts, trust and

[1] 15 U.S.C. §78c(a)(4)(i)-(x).

fiduciary, investment adviser, safekeeping and custody, municipal securities, and transfer agency activities. This exemption was later implemented in Regulation R.[2]

The SEC proposal would impose a wholly duplicative securities-based regulatory regime on the very activities that Congress determined were sufficiently regulated under banking law as to ***not*** to warrant SEC regulation. Such a regime serves no public purpose and would impose substantial costs on banks that will necessarily be passed on to municipal clients. The bottom line is that unless the final rule exempts bank activities, it is the municipalities—the very entities intended to be protected by Section 975—that will be harmed.

ABA's view is also supported by the statute itself. We believe that Congress did not include an exemption for banks because Congress was not thinking of banks' provision of advice to municipalities when it considered Section 975. This view is borne out by the fact that Section 975 amends a statute that provides for examination and enforcement by the bank regulators for those banks that act ***as municipal dealers***. Had Congress been thinking of banks ***as municipal advisors***, it surely would have provided for similar examination by the bank regulators. The fact that it did not is, we believe, because Congress did not intend banks—which are already comprehensively regulated—to be covered by a duplicative securities-based regulatory regime. Nor did Congress provide for a "separately identifiable department" or SID of a bank for municipal advisor activities as it did with respect to municipal dealer activities. A SID permits banks to segregate municipal dealer activities from the rest of the bank.

Another illustration of the fact that Congress was not thinking of banks when considering Section 975 is that the statute provides an exemption from registration for advisers who are required to register under the Investment Advisers Act. Banks that provide investment advice to any person—including municipalities—are exempt from registration under the Investment Advisers Act, because that activity is already sufficiently regulated under banking law. The fact that Section 975 exempts registered advisers because they are already regulated is strong evidence that the same was intended for banks.

We believe Congress' goal was to regulate entities whose municipal advisory activities were ***not*** subject to regulation and to do so by imposing only a single regulatory program on such activities. Heretofore unregulated financial advisors would be regulated by the SEC and the MSRB. The SEC's proposal, by contrast, would impose on bank municipal advisory activities a second and

[2] 17 C.F.R. Part 247.

different layer of regulation on top of federal bank regulation of those advisory activities, unlike the path followed for registered investment advisers.

II. The Final Rule Should Avoid Unnecessary Duplication

Banks provide depository services for municipalities or municipally owned entities, such as our local towns, schools, municipal hospital, airport, fire department, conservancy districts, water districts and others. In addition to providing depository and check services to these entities, banks also provide payroll ACH origination, ACH billing, municipal bond support, and more. It is not unusual for many different employees to assist these entities with CD renewals, payroll origination, payment of warrants and other activities that seem to be the target of their registration as proposed.

Subjecting large numbers of community bank employees to SEC registration, supervision and examination in order to continue to provide basic banking is nothing short of ridiculous. We are not providing these entities with "securities" advice, nor are we conducting any other activities that fall under the traditional registration guidelines of the SEC. And, these same employees would be required to take continuing education to remain registered and would be subject to a fiduciary duty.

Moreover, it is very common for bank employees to serve on one or more unpaid volunteer boards for these entities, including city council, city hospital board, city hospital foundation board, school board and city zoning board among others. Under the proposed rules, these employees would also be subject to registration as individuals and would have to comply with the full regulatory scheme described above. If this regulation is made final, it is likely that bank employees will have to stop some of these activities. This makes no sense and makes our communities poorer.

Let me make this very clear. All of the products and services described above—and more that my bank is too small to provide—***are already regulated and have no connection to municipal securities or "municipal financial products"*** as defined in Section 975 or intended by Congress to be reached by the provision. All of the above bank products are regulated extensively already, and the institutions providing them are supervised and regularly examined by the federal bank regulators.

Some of these products are offered within a bank trust department. For example, banks may serve as advisors to municipal pension plans. Individual municipal employees contribute their own funds to such plans—they are not related to the municipality's securities activities; nor do such funds contain the proceeds of municipal securities issuances. The trust departments of banks that provide advice to municipal pension plans must adhere to the highest standards of fiduciary common law. Moreover, bank trust departments are regularly examined in accordance with such requirements. Indeed, they are examined far more frequently than are investment advisers regulated by the SEC. In addition, many bank products and services offered to municipalities are overseen by state treasurers. ***To impose on these traditional bank products and services an overlay of securities law regulation when offered to municipalities serves no public purpose.***

In addition, the MSRB has proposed guidance on the fiduciary duty of municipal advisors (now withdrawn until the SEC finalizes its registration rule) that would prohibit, as a conflict of interest, a bank that provides a service to a municipality from offering any other service as principal to the municipality. This would lead to absurd results. For example, under the proposed rule, a bank that provided advisory services to a municipal pension plan would be unable to offer deposit accounts to that municipality.

Recordkeeping reporting requirements present another enormous problem should the rule be adopted. The current reporting requirements for banks have long been in place and are tailored to bank structure, capital requirements, and banking activities. The municipal advisor regulatory scheme, by contrast, is a securities-based regime based on traditional investment adviser structures. The cost of complying with a markedly different recordkeeping and reporting system would be substantial and would necessarily be passed on to customers. Further, because of the dispersion throughout a bank of business with municipalities, the entirety of a bank's recordkeeping would become subject to SEC oversight, a result so unnecessarily duplicative of the banking agencies' functions that it begs the question as to what public purpose can be served by such excessive reach.

We believe that the SEC, in its final rule, must state clearly that banks are not covered by Section 975, thus avoiding duplicative oversight by yet another regulatory agency.

III. Small Municipalities Would Have Reduced Access to Basic Banking Services

Let me use another illustration to help you understand just how onerous this new rule could be, if it is implemented in its current form. It is quite common for someone from a public entity to come into a bank branch asking how to set up a simple service, such as a deposit or sweep account. Tellers in that office could give them the basic information about these accounts, although often a branch manager would fill them in on the details.

If this proposal is made final as is, these two activities—both the basic explanation of a deposit account and the detailed one—could require both the teller and the branch manager to be registered as municipal advisors. Not only would they both have to be registered, along with the bank, but the bank itself would then have to undergo scrutiny by yet another regulator—with its own unique set of regulatory standards.

Moreover, if the final rule does not exempt banks and, further, does not provide a definition of advice, banks could be required to register thousands of employees, each of whom would be subject to continuing education requirements established by the MSRB and each of whom would be subject to a fiduciary duty to municipal customers.

Our compliance office is already facing an uphill battle to implement the plans needed to ensure we are compliant with all of the new rules coming from Dodd-Frank. If a new registration, reporting and compliance obligation were to be added, many banks would have to seriously consider whether to continue to provide services—even simple depository services—to the government entities in our community.

It makes no sense whatsoever to create a duplicative system that will end up raising the cost of services to municipal entities, reducing the services available, or forcing some banks to exit the market completely to avoid registration. Such outcomes are unnecessary and benefit neither the bank nor its community.

Conclusion

Section 975 is the result of Congress' intent to impose a regulatory regime on municipal advisory activities that were not previously regulated. To overlay onto traditional bank activities an additional, markedly different securities law regulatory regime and an additional regulator is not in the public interest. It will not provide additional protections for municipal governments, but rather will increase the cost and impair the availability of bank products and services to those bodies. An exemption from registration as municipal advisors must be provided to banks.

We strongly support H.R. 2827 which would clarify what constitutes a municipal advisor and would remove financial institutions from the proposed, ill-defined and inappropriate definition. We urge Congress to enact this important piece of legislation.

Thank you for considering our comments. I am happy to answer any questions.

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Written Statement of

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Submitted to
the
Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
United States House of Representatives

Hearing on the Impact of Dodd-Frank on Municipal Finance

Friday, July 20, 2012

I. Introduction

I am Mike Marz, the Vice Chairman of FirstSouthwest, and a member of the Board of Directors of the Bond Dealers of America (BDA). I am also a former Chairman of the BDA. I have attached to this statement a brief personal resume as well as a general description of FirstSouthwest.

This statement is submitted on behalf of the Bond Dealers of America. The BDA appreciates the opportunity to participate in this hearing. The BDA, with fifty three members headquartered coast to coast, is the Washington, DC, based organization that represents securities dealers and banks focused on the U.S. fixed income markets. The BDA is the only organization representing the unique interests of national, middle-market, sell-side, fixed-income dealers. In addition to federal advocacy, the BDA hosts a series of meetings and conferences specific to domestic fixed income, and spearheads industry cooperation on economic surveys and on market practice documents. Additional information about the Bond Dealers of America can be found at www.bdamerica.org.

Today I will speak from the perspective of fixed-income dealers about why it is so important to get the implementation of Dodd-Frank "right," including striking the right balance in defining and regulating municipal advisors. While our discussion today is about fairly complex rules, I would like to put my job in simple terms to help emphasize why bond dealers like me play an important role in this policy discussion. Bond dealers are a bridge between the infrastructure that serves the public day in and day out, and investors who seek financial security in purchasing the bonds that make public works possible. For example, in my home state of Texas, FirstSouthwest helped the Dallas Independent School District save $150 million in interest payments through a carefully structured issue of Build America Bonds. We also coordinated bonds that will finance three light rail lines in Houston's inner city, and helped the city of Dallas with a cost effective bond issue that will allow them to make improvements to water sewage projects. These types of projects happen every day across the country and if the issuances occur with the prudent advice, structuring and marketing of bond issuances that BDA members provide, governments and their citizens save money while enjoying the benefits of public infrastructure.

II. Regulation of Municipal Advisors

The BDA has concerns regarding how the Dodd-Frank Wall Street Reform Act of 2010 (Dodd-Frank or DFA) is being implemented, and we are working with regulators to ensure the "Volcker Rule" does not create unintended consequences for the municipal securities market. I will focus this testimony, however, on our support for DFA Section 975 that requires the Securities and Exchange Commission (SEC or Commission) to adopt rules mandating that municipal advisors register with the SEC. Section 975 also requires the Municipal Securities Rulemaking Board (MSRB) to adopt rules governing the behavior and activities of municipal advisors. Our comments are focused on the differences between the comprehensive regulatory regime applicable to broker dealers, particularly those acting as financial advisors ("regulated dealer advisors"), and the continuing complete lack of regulation of independent financial advisors ("unregulated municipal advisors").

Almost two years after the enactment of Dodd-Frank and despite the requirement for new rules for municipal advisors, virtually anyone can act as a non-dealer municipal advisor to an issuer of municipal securities, regardless of qualifications, political contributions, or conflicts of interest, while more and more restrictions are focused on broker dealers, including regulated dealer advisors. This seems exactly the opposite of what Dodd-Frank intended. We believe that in the case of rules for financial advisors, regulators of the municipal securities industry should create a level playing field for currently unregulated municipal advisors and broker dealers acting as advisors, recognizing that both provide important services -- in some cases, the same services -- that issuers desire.

By way of background, in October 2009, SEC Commissioner Elisse Walter delivered a speech where she said she found the conduct of some municipal advisors "alarming" and that they were engaging in "pay to play" practices, that there were undisclosed conflicts of interest, that advice was rendered by advisors without adequate training or qualifications, and that there was a failure to place the duty of loyalty to their clients ahead of their own interests. Commissioner Walter asked for the authority to regulate these independent municipal advisors and in Section 975 of Dodd-Frank, the Commission received such authority. Supporting this sense of urgency, unregulated municipal advisors have represented clients in high-profile public finance disasters, such as the bankruptcy of Jefferson County, Alabama and New Mexico bond deals that were fraught with pay-to-play improprieties and bid rigging that led to the convictions of CDR Financial Products executives - unregulated municipal advisors – on wire fraud and conspiracy charges.

The SEC has not made progress to date in resolving the problems that alarmed Commissioner Walter. The first step is for the SEC to issue a definition of municipal advisor that is narrowly and appropriately focused on those who advise on the issuance of municipal bonds and on the investment of bond proceeds. Until that occurs, the Commission cannot undertake step two: regulate independent municipal advisors to stop pay to play, require conflicts to be disclosed, and impose adequate professional standards. In BDA's view, defining "municipal advisor" and regulating those advisors should be the focus of the Commission's rulemaking initiative.

A. Definition of Municipal Advisor

BDA has joined with many in the municipal bond community pointing out that the definition of municipal advisor proposed by the SEC pursuant to Dodd-Frank is overly broad and ambiguous. While the SEC has indicated they recognize this, they have yet to correct it. For example, the SEC's proposed regulations (Release No. 34-63576) fail to exclude appointed and volunteer municipal board members from the definition of municipal advisors. Moreover, the proposed regulations do not define the term "advice," which has implications for bond dealers and municipalities alike. Volunteer and appointed members of the boards of a municipal entity would be subject to considerable doubt as to whether their activities result in "advice." Likewise, it would not be clear whether underwriters provide information constituting "advice" which could require registration as a municipal advisor. On the other hand, Dodd-Frank exempts underwriters from the term "municipal advisor" -- but it isn't clear how to distinguish between a municipal advisor and an underwriter.

The goal for the SEC should be to provide a simple mechanism for regulators and industry participants to determine if they are acting as a municipal advisor. BDA recommends that the SEC and other applicable regulators implement an approach that permits a party to use a disclaimer to disclose to other parties that it is not acting as an advisor. The fundamental characteristic of an advisor under Dodd-Frank is that there is not an arm's length relationship. If the client is provided with a disclaimer that the relationship is in fact arm's length, then it has no basis for assuming an advisory relationship. Similar to the approach taken under the swap rules, a broker dealer would not be considered to be a municipal advisor if (1) the broker dealer is acting in the capacity of an underwriter, (2) the broker dealer is not being separately compensated to provide financial advice, and (3) the broker dealer discloses to the issuer that it is participating in the transaction on an arm's length basis and is not a fiduciary to the issuer. We believe that the rule should make it very clear when such a disclaimer must be presented. We also believe the disclaimer should be required no earlier than when an underwriter provides its materials to an issuer for a proposed issuance or in a response to a request for proposals.

B. Regulating Municipal Advisors

Once the SEC has identified a more narrow and appropriate definition of municipal advisor, the next step is for the SEC and MSRB to appropriately regulate the current unregulated municipal advisors. The regulatory approach should include testing and licensing, supervision, compliance examinations, record keeping, restrictions on political contributions and other requirements that already apply to regulated dealer advisors.

i. Roles of Regulated Dealer Advisors, Underwriters and Unregulated Muni Advisors

To explain why regulation is needed, it may be helpful to describe the roles that regulated dealer advisors and underwriters (functions performed by BDA members) and unregulated municipal advisors play in public finance transactions. A great many issuers use either dealer advisors or unregulated municipal advisors and underwriters in combination. The underwriter can purchase a bond issue in order to sell those bonds to investors, thus directly facilitating the issuer's efficiency in raising funds. An unregulated municipal advisor can help to structure the bond issue, determine the fair value price for the issuer and help to select the underwriter, as well as provide investment advice, swap advisory services or arbitrage rebate. Dealer financial advisors can play those roles as well, but have the advantage over unregulated financial advisors of being part of firms that participate in the buying and selling of municipal securities every day, thus having real-time current market knowledge. While unregulated financial advisors may serve as a pricing agent for the bond, they lack the real-time market data to directly or most accurately determine the price. The value to issuers of the market experience of broker dealers should not be underestimated and is the reason many issuers choose to hire regulated financial advisors.

ii. Closing the Regulatory Gap

Although underwriters or dealer financial advisors and unregulated muni advisors all play roles together and even similar roles, their level of regulation is dramatically different. Let me describe the differences between the compliance and regulatory measures required of bond dealers, including dealer financial advisors, and what is required of unregulated municipal advisors that lack the same obligation dealers have for fair dealing (although unregulated muni advisors have a fiduciary duty at the state level and per the Dodd-Frank bill). The chart below outlines standards imposed upon broker dealers by the MSRB and SEC and which are not required of unregulated municipal advisors.

Regulatory Requirements	**Regulated Broker-Dealer Advisors**	**Unregulated Municipal Advisors**
MSRB Regulation	x	
SEC Regulation	x	
Regular and Random Audit Compliance Reviews	x	
Licensing Requirements	x	
Continuing Ed Testing	x	
Written Supervisory Procedures	x	
Restrictions on Political Contributions	x	
Restrictions on Gifts and Entertainment	x	
Record Retention Requirements	x	
Obligations and Requirements for Fair Dealing	x	
Disclosures on Compensation, Third Party Fees and Conflicts of Interest	x	
FINRA*	X	

*Provides additional requirements for broker dealer firms handling customer money.

As this chart demonstrates, dealer advisors are heavily regulated even beyond the regulations that apply due to handling customer accounts. Municipal advisors simply lack regulation, and while it does not make sense to subject them to all of the restrictions applicable to broker dealers, a similar set of comprehensive regulations must be implemented. Municipal advisors do have a state level fiduciary duty but that is not a replacement for regulation as can be seen by the Jefferson County case and other cases of bad actors in the public finance arena. And, while Dodd-Frank states that municipal advisors have a fiduciary obligation, it has in no way been given practical effect in the case of unregulated municipal advisors. As one example, the protection provided to a party who engages a fiduciary, if that fiduciary fails to carry out its fiduciary obligation, is compensation for losses for which the fiduciary is responsible. But without advisor capital requirements, and given that many of these unregulated firms have minimal assets, the fiduciary standard can not impose consequences that make the advisor's fiduciary responsibility to an issuer have practical meaning.

III. SEC Rulemaking Initiative and H.R. 2827

As mentioned above, on December 20, 2010, the SEC issued proposed rules to implement the provisions of Section 975 of the DFA. As also set forth above, the BDA is of the view that the SEC's proposed rules went far beyond the narrowly focus definition of municipal advisor intended by Congress. Even SEC Chairman Schapiro acknowledged as such in testimony before the House Financial Services Committee.

It is past time for the Commission to get this rulemaking initiative back on track. Many members of this Subcommittee signed a letter to Chairman Schapiro on December 19, 2011, recommending that "the Commission should promptly scale back the scope and application of the proposed rules to define the term 'municipal advisor' as Congress intended." The BDA agrees.

Last year, Congressman Dold introduced H.R. 2827, which emphasizes that the Commission should bring its municipal advisor rulemaking initiative back on track as soon as practicable. H.R. 2827, which is now cosponsored by 35 other House Members, would clarify the language of DFA Section 975 to more clearly specify the scope and limits of the SEC's municipal advisor rulemaking definition. The BDA supports H.R. 2827, especially the part of Section 1 that would exclude already regulated dealer advisors, elected or appointed members of state or local governing bodies and others from the definition of municipal advisor. We also support the part of Section 2 that clarifies what funds constitute the types of funds and investments that are subject to the municipal advisor rules.

Clarification of the definition of a municipal advisor under H.R. 2827 is a strong step in the right direction if combined in the future with step two: a set of regulations parallel to those already embraced by regulated dealer advisors. These two steps will ensure that unregulated municipal advisors act in the interest of their clients. This will help prevent fraud that has, under the Jefferson County and CDR examples, harmed cities and the citizens they serve.

IV. Conclusion

The SEC needs to move forward on a definition of municipal advisor so that investors and state and local governments can receive the protection that Congress intended in Dodd-Frank. The first step to fix this situation is for the SEC to define who is a municipal advisor, appropriately and narrowly. The second step, simply stated, is for unregulated municipal advisors to be appropriately regulated.

By significantly cleaning up the ambiguous definition of municipal advisor under Dodd-Frank, we believe that H.R. 2827 may provide the SEC with the boost they need to proceed with the rulemaking initiative required by Section 975 of Dodd-Frank almost two years ago.

Again, the Bond Dealers of America appreciates the opportunity to submit this written statement to the Subcommittee on Capital Markets and Government Sponsored Enterprises. If you have any questions or need any further information, please either contact myself, or contact Mike Nicholas, the Chief Executive Office of the BDA, at 202-204-7901 or at mnicholas@bdamerica.org.

MSRB
Municipal Securities Rulemaking Board

Written Statement of Alan D. Polsky
Chair
MUNICIPAL SECURITIES RULEMAKING BOARD

Testimony on The Impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act on Municipal Finance
House Subcommittee on Capital Markets and Government Sponsored Enterprises
Washington, D.C.
July 20, 2012

Good morning Chairman Garrett, Ranking Member Waters and members of the Subcommittee. I appreciate the invitation to testify today on behalf of the Municipal Securities Rulemaking Board (MSRB). My name is Alan Polsky and I am Chair of the MSRB. I am also senior vice president of Dougherty & Co., LLC, a Minneapolis, Minnesota-based investment banking firm.

The MSRB was created by Congress in 1975 as the principal regulator for the municipal securities market with the mandate to protect investors and the public interest. By adopting a principles-based approach to regulating municipal securities dealers, operating retail-oriented information disclosure systems and establishing professional standards for municipal securities professionals, the MSRB has effectively created protections for retail investors in the $3.7 trillion United States municipal securities market.

The MSRB also acts as an independent resource and expert on the municipal securities market for policymakers such as Congress and the U.S. Department of the Treasury as well as other federal and state regulators including the Board of Governors of the Federal Reserve and the Internal Revenue Service.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) included multiple provisions that affect the municipal market and the MSRB. The provisions relating to the MSRB's rulemaking and related activities became effective on October 1, 2010. Specifically, Section 975 broadened the mission of the MSRB to include the protection of state and local governments, as well as certain private sector obligated persons — such as universities and hospitals — that access the capital markets through the issuance of municipal bonds. The MSRB, of course, also continues to pursue its original mission of protecting investors and the public interest.

Section 975 of the statute expanded the MSRB's responsibilities to include the regulation of municipal advisors. Municipal advisors include businesses and individuals that advise municipal entities concerning municipal financial products and municipal securities, as well as businesses and individuals that solicit certain types of business from municipal entities on behalf of unrelated broker-dealers, municipal advisors or investment advisors. Municipal securities dealers performing municipal advisory services were previously subject to MSRB regulation because of their municipal securities dealer activities. Under the new law, however, other municipal advisors are subject to MSRB regulation for the first time.

The MSRB's Board of Directors was reorganized under our amended authorizing statute to be made up for the first time of a majority of public, independent members and to include municipal advisor representatives. Previously, the Exchange Act required that the MSRB be governed by a board with a majority of industry members. Under the new structure, effective October 1, 2010, the MSRB is required by statute to maintain a balance of regulated and non-regulated Board members, with investors, municipal entities, securities dealers, bank dealers and municipal advisors each having representation on the MSRB Board of Directors.

Protection of State and Local Governments

Over the last two years under its majority public Board, the MSRB has acted to enhance disclosure and transparency measures to comply with the new law to protect a broader array of participants in the municipal market. The MSRB has undertaken its expanded mandate to strengthen protections for state and local governments — and the taxpayers who support municipal borrowing.

The role of the MSRB in protecting state and local governments is critical because these entities raise, through the issuance of bonds, notes and other debt obligations, an average of nearly $450 billion in the capital markets each year.[1] The municipal bond market has evolved from one in which states and municipalities offered traditional, general obligation fixed rate bonds to finance specific projects to one that involves the use of various security structures, complex derivative products and intricate investment strategies, and the presence of an ever-expanding group of service and product providers, advisors and sales teams.

Many of the bond transactions undertaken by state and local governments are complex transactions involving sometimes dozens of financial, legal and other players, each of whom represents his or her own interests and often has conflicts tied to an additional and often invisible set of market participants. Moreover, compensation of participants in a municipal finance transaction in almost all cases is contingent on the completion of the deal, creating incentives that put unknowing state and local governments at risk of inappropriate and unsuitable transactions and products — at the expense of taxpayers and ratepayers.

[1] Thomson Reuters SDC Platinum database on new municipal issuance from 2007-2011

In the vast majority of cases, state and local government officials are unfamiliar with the mechanics of a municipal finance transaction. At the local level, many are part-time staff. As public servants, these individuals are responsible for representing the interests of their communities, their taxpayers and their ratepayers, but in many cases, they lack the experience and/or expertise needed to assess the terms of the structures presented to them by financial professionals recommending structures and products. Transactions involving interest rate swaps and other complex structures further complicate the situation. In cases such as these, state and local governments can hire a municipal advisor or advisors but need to have the confidence that they represent their best interests.

As Committee Chairman Spencer T. Bachus wrote in 2009, "Although local governments frequently tap the municipal finance market to raise funds to pay for long-term projects, conflicts of interest and complexity in the municipal finance market can sometimes trap the unwary, particularly when local officials lack the expertise to independently assess the terms of the financing structures proffered by sophisticated underwriters."[2]

State and local governments are not the only ones who can lack expertise. Unqualified municipal advisors recommending ill-advised or unsuitable transactions to state and local governments can compound the challenges they face. Like underwriters of municipal securities, these advisors can have multiple undisclosed ties to other market participants that can threaten the integrity of the advice given to state and local governments. Until now, many market professionals acting as financial advisors to state and local governments have, by and large, been exempt from meeting any standards of quality, professionalism and expertise.

High profile examples like the Jefferson County, Alabama bankruptcy,[3] municipal bid-rigging convictions obtained by the U.S. Department of Justice,[4] unsuitable derivative transactions sold to local governments[5] and guarantees provided by localities for corporate projects that have

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[2] Federal Policy Responses to the Predicament of Municipal Finance, Congressman Spencer T. Bachus, Cumberland Law Review, 2009.

[3] In re *Jefferson County, Alabama* Chapter 9 Case No. 11-05736-TBB-9, U.S. Bankruptcy Court for the Northern District of Alabama (November 9, 2011) ("Jefferson County Bankruptcy").

[4] *See, e.g.*, U.S. v. Carollo, 10-cr-00654, U.S. District Court, Southern District of New York (July 27, 2010); U.S. v. Rubin/Chambers, Dunhill Insurance Services Inc., 09-CR-01058, U.S. District Court, Southern District of New York (October 29, 2009). Allegations regarding bid rigging have been raised in other venues as well. *See also* SEC Complaint 1, SEC v. J.P. Morgan Securities LLP, Case No. 2:11-cv-03877 (D.N.J. July 7, 2011) (alleging fraudulent bidding practices by J.P. Morgan Securities in at least 93 municipal bond reinvestment transactions); SEC Litigation Release No. 21956, Securities and Exchange Commission v. UBS Financial Services Inc. (May 4, 2011) (alleging fraudulent bidding practices by UBS Financial Services in at least 100 municipal bond reinvestment transactions); In the Matter of Banc of America Securities LLP, Exchange Act Release No. 63451 (December 7, 2010) (alleging fraudulent bidding practices by Banc of America Securities in at least three municipal bond reinvestment transactions).

[5] Jefferson County Bankruptcy.

defaulted[6] illustrate the price of gaps in regulation of the municipal securities market. Local governments, rather than being able to turn to a trusted financial advisor to help defend against questionable advice, practices and complex products, in these cases instead received advice of questionable quality from unregulated financial advisors.

Many states, counties and communities across the country face this same alignment of professionals that, rather than serving the best interests of their state or local government clients, can serve to provide an avenue for taking advantage of financially less sophisticated public servants.

With a Congressionally mandated role to protect state and local governments, the MSRB has assessed and is amending its existing regulations for banks, broker-dealers and municipal securities dealers to explicitly protect state and local governments. These changes are intended to ensure that dealers follow rigorous fair-practice and other standards, and that state and local governments have the information they need to make appropriate decisions.

The MSRB has also developed the framework for a principles-based regulatory regime that would establish regulations for municipal advisors and protect state and local governments. These include draft rules on conflicts of interest, including pay-to-play.

I'd like to go in to some more detail about these draft rules so the Subcommittee has an understanding of the philosophy and consistency of the approach to municipal advisor regulation compared to that of dealers, and how the MSRB's draft rules would establish fair practice and other rules for the two groups of financial professionals with arguably the most extensive influence and contact with state and local governments.

Draft Municipal Advisor Rules

The MSRB is directed by statute to adopt rules for municipal advisors in a number of areas, including, among other things: (1) prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, enhance mechanisms of a free and open market, and protect investors, municipal entities, and obligated persons; (2) prescribe means reasonably designed to prevent acts, practices, and courses of business that are not consistent with a municipal advisor's fiduciary duty to its municipal entity clients; (3) prescribe professional standards; (4) provide continuing education requirements; and (5) provide for periodic compliance examinations. The MSRB is directed to not impose a regulatory burden on small municipal advisors that is neither necessary nor appropriate to the public interest and the protection of investors, municipal entities and obligated persons, provided that there is robust protection of investors against fraud.

Beginning in October 2010, the MSRB undertook an extensive outreach effort to solicit input

[6] *See, e.g.*, Report of the Missouri House Interim Committee on Government Oversight and Accountability Mamtek Report, (February 2012) and Yvette Shields, *Lombard Draws on Reserves*, The Bond Buyer (January 5, 2012).

from market participants and the public on the type and nature of regulations needed to protect state and local governments. At the same time, the MSRB conducted extensive analysis of its existing rules for municipal securities dealers and studied the nature of the professional services provided by municipal advisors.

Following this outreach and analysis, the MSRB began to lay the foundation for municipal advisor regulation under our expanded statutory mandate. As one of the MSRB's initial municipal advisor rules, the MSRB extended its fair dealing rule, MSRB Rule G-17, to cover the actions of municipal advisors. MSRB Rule G-17 provides that, in the conduct of its municipal securities and municipal advisory activities, each dealer and municipal advisor must deal fairly with all persons and may not engage in any deceptive, dishonest or unfair practice. This "fair dealing" rule is key to defining the relationships of dealers and municipal advisors with investors and issuers, serving as the core to the MSRB's principles-based approach to regulation and as the basis for numerous enforcement actions to address misbehavior in the marketplace.

Also, since October 1, 2010, Section 975 of the Dodd-Frank Act has imposed a federal fiduciary duty on municipal advisors to state and local governments when providing financial advice. Specifically, the MSRB proposed a new rule and an associated interpretation covering the details of an advisor's fiduciary duty. The proposed regulation would, consistent with the obligations of other types of fiduciaries under federal or state laws, require municipal advisors to act consistent with the basic duties of loyalty and care by, among other things, acting in the best interests of their state or local government clients and disclosing all material conflicts of interest. The proposed regulations would address these basic duties in the context of the relationships and activities between state and local governments and their municipal advisors. The proposed rule notes, for example, that municipal advisors must not undertake an engagement when an unmanageable conflict exists, must not charge excessive compensation, and must review reasonably feasible alternatives to proposed products and transactions when advising their state and local governments of a particular financing.

Prohibiting conflicts of interest on the part of financial professionals that can undermine the integrity of the municipal market is an important aspect of many MSRB regulations. One form of conflict of interest in the municipal market can arise if financial professionals seek to influence the award of business by state and local government officials by making political contributions to those officials or soliciting contributions on their behalf. This activity can have a negative impact on market fairness and public confidence in municipal capital markets.
In 2011, the MSRB proposed a rule that would regulate so-called "pay to play" activities of municipal advisors, as well as firms and individuals that solicit certain business from municipal entities on behalf of others. Modeled after MSRB rules in place since 1994 for municipal securities dealers doing business with state and local governments, the proposed rule seeks to sever any connection between political contributions to municipal officials and the awarding of advisory service business to municipal advisors. Like municipal securities dealers, municipal advisors would be prohibited from engaging in business with municipal entities for two years if the firm or their municipal professionals make certain political contributions to state or local

government officials with authority to hire such municipal advisors. The proposed rule would also institute requirements designed to prevent circumvention through indirect activities and would require quarterly disclosures of certain information concerning municipal advisor political contributions to the MSRB, which would make the information available to the public through its website, at www.msrb.org.

The MSRB proposed several other rule changes designed to ensure that state and local governments are protected from potentially unfair conduct on the part of municipal advisors. These draft rules include: (1) restricting the use of gifts to curry favor with employees controlling the award of municipal business; (2) establishing basic standards of fairness and accuracy in advertising and other promotional materials; (3) providing guidance on fair practice duties toward obligated persons; and (4) establishing basic supervisory requirements for municipal advisors based in part on existing municipal securities dealer supervisory requirements but simplified and appropriately tailored in recognition that most municipal advisors are small firms with less complex structures.

Finalization of the MSRB's proposed municipal advisor rules have been put on hold pending completion by the Securities and Exchange Commission (the SEC) of its pending rule proposal to more clearly delineate the breadth of professionals covered under the new statutory definition of municipal advisors. The MSRB expects to complete its initial phase of municipal advisor rulemaking outlined above following resolution of the definition by the SEC.

Professional Qualifications of Municipal Advisors

In addition developing draft rules for municipal advisors to implement Section 975 of the Dodd-Frank Act, the MSRB began the process of establishing minimum professional qualifications for municipal advisors. This work started in October 2010 when the MSRB began conducting outreach events and focus groups to gather input from municipal advisors and others about the development of a professional qualification examination for assessing the competency of entry-level municipal advisors. The MSRB subsequently organized a municipal advisor examination working group to consider all comments received by the MSRB, assess commonalities in municipal advisory activities, provide additional input and assist in the drafting of a content outline for an examination.

Prior to finalizing the initial qualification exams after final SEC rulemaking on its definition of municipal advisor, the MSRB will survey registered municipal advisors about the proposed examination content to ensure it is properly tailored to their functions in the marketplace.

Expanded Obligations for Underwriters

As part of the MSRB's implementation of Section 975, the MSRB also reviewed the existing obligations of underwriters of municipal securities to state and local governments. As a result of this assessment, the MSRB determined that additional protections for state and local governments were necessary. These important new protections, in the form of a new interpretive notice to MSRB Rule G-17 on fair dealing, take effect August 2, 2012.

The interpretive notice significantly clarifies the different roles, responsibilities and relationships of the financial professionals involved in municipal bond deals, and highlights for state and local governments the risks and characteristics involved in complex municipal financings.

Beginning August 2, 2012, an underwriter must disclose to its state or local government client that an underwriter's primary role is to purchase securities for distribution in an arm's-length commercial transaction and that it has financial and other interests that differ from those of its client. While the nature of this relationship may be clear to some, state and local governments that are not in the capital markets on a regular basis may not be aware that an underwriter and an issuer have an arms-length relationship. On the other hand, municipal advisors have a fiduciary duty to act in the best interests of their state and local government clients.

As part of the MSRB's effort to clarify the difference in these relationships to the issuer, the interpretive notice requires an underwriter to disclose that, unlike a municipal advisor, it does not have a fiduciary duty to its state or local government clients and, therefore, is not under a duty to subordinate its own financial or other interests to those of its clients. The underwriter must also disclose to the state and local government client any third-party relationships that may introduce conflicts of interest, including payments or profit-sharing arrangements with third parties, as well as the issuance or purchase of credit default swaps on the issuer's securities.

The new interpretive notice also requires underwriters to disclose the material financial characteristics and risks of complex municipal securities financings to help ensure that state and local governments understand the features, risks and characteristics of transactions recommended by an underwriter so they can make the best decision for their particular situation.

The MSRB continues to reevaluate other existing dealer regulations in light of the explicit mandate to protect state and local governments, and is considering changes where necessary. This effort includes addressing rules related to ensuring that underwriters honor the intention of state and local governments in selling certain portions of their bonds to retail investors and also to improving the availability of current information about initial offering prices or yields of new issues of municipal securities, among others.

Market Transparency, Education and Outreach

Part of the MSRB's effort to safeguard state and local governments over the last two years has been to make them aware of information that helps them make appropriate decisions. The MSRB's Electronic Municipal Market Access (EMMA) website, at http://emma.msrb.org, has dramatically improved the availability of information about the municipal market. This free, public website operated by the MSRB is the official source of municipal market documents and data, helps state and local governments evaluate trading activity, and provides them with a free and centralized avenue for disseminating disclosure documents and related information on their municipal securities to their investors, taxpayers and other stakeholders. The EMMA website houses offering documents for almost every municipal security issued in the United States, secondary market disclosures that provide valuable information about the issuer of a bond throughout its life, real-time trade prices, interest rates and liquidity documents for variable rate securities, and other relevant information, including current credit ratings from rating agencies agreeing to make such information freely available to the public.

EMMA provides enormous benefits to investors, state and local governments, and other market participants because it ensures free, convenient and easy access to information that is essential for making investment and other decisions related to municipal securities. EMMA has been embraced by all categories of municipal market professionals, including regulated municipal securities dealers and municipal advisors, state and local governmental issuers, institutional and retail investors, other professionals that support issuers, and the general public. EMMA has been recognized broadly by the national financial press as a critical tool for retail investors who seek to be self-directed investors or who simply want more information about their investments or a way to check on the quality of service their brokers or investment advisors are providing.[7]

In 2011, the MSRB also began expanding its online tools for state and local governments, including videos and fact sheets about what to expect when working with municipal securities dealers and advisors, the continuing disclosure obligations of state and local governments, and using the EMMA website to communicate with investors.

The MSRB has also engaged in a proactive effort to communicate with state and local government issuers regarding the development of rules for municipal advisors and how the MSRB can effectively protect state and local governments through regulation and market transparency. This type of outreach by the MSRB has encouraged further discussion of the most efficient and effective means of ensuring the fairness and transparency of the municipal market for all participants.

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Response to H.R. 2827

The MSRB has been asked by this Subcommittee to provide its views with regard to Congressman Robert Dold's bill, H.R. 2827, that would amend Section 975 of the Dodd-Frank Act, and more generally on Titles VII and IX of the Dodd-Frank Act.

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[7] *See, e.g., Forbes Magazine*, "Finally, An Easy Way To Get Timely Municipal Bond Data," July 9, 2012; *Smart Money*, "Muni Bonds Require More Attention Nowadays," July 10, 2012; *Wall Street Journal*, "A Site to Check Municipal Bond Ratings," November 19, 2011; *New York Times*, "In Uncertain Times, Municipal Bonds Call for Caution," October 18, 2011; *New York Times*, "Fresh Air in the Muni Market," August 20, 2009.

Congressman Robert Dold's bill to amend the Securities Exchange Act to clarify provisions relating to municipal advisors addresses the definition of municipal advisors and certain related definitions, and proposes to eliminate the federal fiduciary standard for municipal advisors. The MSRB would like to provide the Subcommittee with information useful in its consideration of the implications of the HR 2827's proposed expanded exclusions from the municipal advisor definition and removal of the federal fiduciary standard.

Section 975 of the statute currently provides a broad definition of municipal advisor. However, before the statute was established, many market professionals acting as financial advisors to state and local governments had, until 2010, been exempt from meeting any standards of quality, professionalism or professional conduct. This regulatory gap resulted in an array of firms and individuals that could simply declare themselves financial advisory professionals and begin advising state and local governments on capital market financings ranging from the tens of thousands of dollars to many billions of dollars. The skills, experience and professionalism of these financial advisors have ranged from the highest-minded expert professionals, on one end of the spectrum, to advisors that have no basis – professional or ethical – to be relied upon to provide qualified and un-conflicted advice to the public sector. It is important to ensure that the professionals on whom state and local governments rely for independent advice are properly qualified and regulated.

Putting aside, for the moment, the nuances of Section 975 in terms of the definition of municipal advisor, the MSRB is well positioned to assume the task of addressing the statutory requirement to ensure that state and local governments are adequately protected.

Definition of Municipal Advisor

In December 2010, the SEC issued a rule proposal to establish a permanent registration regime for municipal advisors (Proposed Exchange Act 15Ba1-1). The proposed rule was intended, in part, to provide greater clarity on the definition of municipal advisors. This proposal proved to be rather controversial, resulting in over 1,000 comment letters questioning many aspects of the definition.

Like Congressman Dold, the MSRB is concerned about the effects of an overly broad definition of municipal advisor. In February 2011, the MSRB submitted a comment letter to the SEC[8] that recommended several specific changes related to the efficiency of the proposed municipal advisor registration process and the scope of the definition of municipal advisor.[9] Consistent with the provisions of HR 2827, the MSRB also recommended excluding from the definition of municipal advisor not only municipal entities and employees of municipal entities,

[8] MSRB Comment Letter to the Securities and Exchange Commission on Proposed Rules on Registration of Municipal Advisors (File No. S7-45-10), February 22, 2011.

[9] For example, the MSRB recommended an approach to municipal advisor registration that parallels the current process undertaken by the SEC for registering municipal securities dealers, which would reduce considerably the burden on individuals associated with municipal advisors and streamline the process at the firm level.

but also any member of the governing body of a municipal entity regardless of how the membership is determined. This exclusion would apply when the employees or members were acting within the capacity of their jobs. The MSRB further recommended excluding similar employees, directors and officers of obligated persons from the definition of municipal advisor when they are acting on their own behalf and providing internal advice with respect to municipal financial products or the issuance of municipal securities.

More generally with regard to the definition of municipal advisor, the MSRB understands the need to avoid regulatory duplication – that is, requiring professionals to comply with two different rulebooks covering the same sets of activities. The MSRB offers two general observations we believe will help achieve the elimination of regulatory duplication without creating regulatory gaps. Such gaps should be avoided since they could result in regulatory arbitrage at the expense of the protection of state and local governments.

When creating exclusions for professionals already subject to another regulatory regime, it is important to consider whether these regulatory regimes specifically cover these professionals' municipal advisory work with state and local governments. A comprehensive "scope-based" approach that limits exclusions to activities otherwise subject to regulation could represent a solution to the challenge of regulatory gaps.

H.R. 2827 takes a scope-based approach for certain categories of exclusions but not for others. For example, its exclusion of SEC- or state-registered investment advisers is not scope-based, raising the likelihood that certain activities engaged in by investment advisers – such as, for example, advice to a state or local government on the structuring of a bond offering or of other plans, programs or investment pools – would be exempted from the coverage of the municipal advisor provisions. However these activities also would not be regulated under investment adviser regulations promulgated by the SEC and the various states since new issue or other program structuring advice to state and local governments would likely not be viewed as investment advice subject to the existing regulatory schemes of the SEC and the states.

The exclusion for financial institutions provided for in H.R. 2827 also creates the potential for regulatory gaps with respect to advice provided to state and local governments. Banking regulations are designed to address, first and foremost, the safety and soundness of the banking system, but are not designed to regulate the structuring of a bond offering or other non-banking activities and services that financial institutions may provide to state and local governments.

On the other hand, we believe H.R. 2827's approach to an exclusion from the definition of municipal advisor for those professionals involved with swaps or security-based swaps (collectively referred to as "swaps") is scope-based and therefore appropriately addresses the need to protect state and local governments. The exclusion for municipal advisors registered with the Commodity Futures Trading Commission (the CFTC) or the SEC would be limited in scope to their advice on, engagement in, or arrangement of a swap and is not likely to create a significant regulatory gap. This depends on the existence of SEC and CFTC rules applicable to these professionals covering the provision of advice to a state or local government (referred to under Title VII of the Dodd-Frank Act as "special entities") with respect to swaps. This scope-based exclusion would appropriately continue to treat these professionals as municipal advisors if their advice to state or local governments relates to matters other than their swap activities.[10]

The MSRB therefore believes that the best approach with respect to exclusions to the definition of municipal advisor would be to make them all scope-based, so that these entities are excluded only when the activities they undertake are otherwise subject to regulation that provides for the protection of state and local governments.

The MSRB's second observation on regulatory duplication relates to H.R. 2827's exclusions from the definition of municipal advisor to associated persons of market participants. Because the term "associated person" under the federal securities laws can include any person within entities under common control of a corporate parent such as a bank or financial holding company, a blanket (that is, non-scope-based) exclusion for associated persons could result in their day-to-day municipal advisory activities having no regulation whatsoever — either as a municipal advisor, an investment adviser or a financial institution because the regulation of the parent company may not address the municipal advisory services to state and local governments. Such a scenario could reduce protection of state and local governments and again raise the possibility of certain professionals benefiting from regulatory arbitrage.

The Subcommittee should also consider that a wholly unintended and undesirable result of a blanket, non-scope-based exclusion for associated persons could be that only those municipal advisory firms that are fully unaffiliated with larger corporate parents — the vast majority of which are very small businesses — would be subject to regulation as municipal advisors while firms that are part of large financially-oriented corporate families would be left unregulated. This would be the antithesis of the Congressional determination that regulation of municipal advisors be designed not to impose a regulatory burden on small municipal advisors given that their larger competitors would be free of all regulation.

Federal Fiduciary Duty

I would now like to address the issue of a federal fiduciary duty for municipal advisors and H.R. 2827's elimination of this duty. The MSRB is concerned, above all, in protecting state and local governments in the context of their municipal finance transactions. We recognize that it is up to the Subcommittee and Congress to determine whether a federal fiduciary duty for advisors is appropriate and think that we can offer helpful considerations in that determination.

In a relationship of trust between a state or local government and a municipal advisor, a fiduciary duty applies by virtue of common law.[11] The existing fiduciary duty may not be a

[10] To further reduce the potential for regulatory duplication and regulatory gaps, the MSRB recommends that the SEC and CFTC, which are directed under Title VII of the Dodd-Frank Act to coordinate their regulatory activities with one another with respect to swaps, should be further directed to coordinate their regulatory activities with the MSRB with respect to swap activities involving special entities, where expertise on the specific needs of state and local governments resides within the federal securities regulatory expertise of the MSRB.

federal one, but it exists nonetheless, whether labeled formally as a fiduciary duty, a duty of trust, a duty arising from an agent-principal relationship, or any other such other label.

If the federal fiduciary standard were to be eliminated, there would still be applicable fiduciary duty standards in each of the fifty states. Each state could fashion appropriate laws taking into account the unique needs of the localities within its jurisdiction. Municipal advisors would continue to be required to comply with the separate state laws in each of the jurisdictions in which they practice. Eliminating a federal fiduciary duty would reinforce state fiduciary duty laws and perhaps encourage more vigorous state-level enforcement in effectively preventing scandals in the municipal market. However, eliminating the federal fiduciary duty would require municipal advisors to understand the varying standards from state-to-state. Uneven enforcement of such standards that depend on the degree of vigor in pursuing enforcement from state-to-state also would continue.

Retaining a federal fiduciary standard for municipal advisors would provide the national municipal marketplace with a single, consistent set of rules for municipal advisors who operate locally, regionally and nationally. A clear and uniform understanding of their legal duties will give rise to the level of consistency needed to maintain a fair and efficient national market in municipal securities. A federal fiduciary duty would also provide state and local governments with a clear understanding and expectation of the obligations of their municipal advisors. MSRB rules would articulate clearly what is meant by this duty of loyalty.

As I mentioned earlier, once the SEC moves forward with a definitional rule for municipal advisors, the MSRB will re-release draft rule proposals relating to how such federal fiduciary rule would be applied. Rulemaking on the federal fiduciary standard and on other key municipal advisor rule proposals was suspended precisely to provide municipal advisors — once they know who they are — with the opportunity to study the proposals and to provide meaningful comments to the MSRB prior to the rules being filed with the SEC to complete the rulemaking process.

Retaining a federal fiduciary duty will enable municipal advisors and other market participants to provide their analysis and suggestions for better refining these regulatory proposals — particularly with regard to questions of balancing the benefits of a rigorous set of regulatory standards with the relative burden of compliance with such new standards, as well as potential consideration of alternative approaches to achieving the same objectives. The ability of the marketplace to engage in a conversation with the MSRB regarding the appropriate construction and application of a federal fiduciary duty is far greater than the ability of market participants to influence any necessary evolution of common law fiduciary standards upheld by state courts

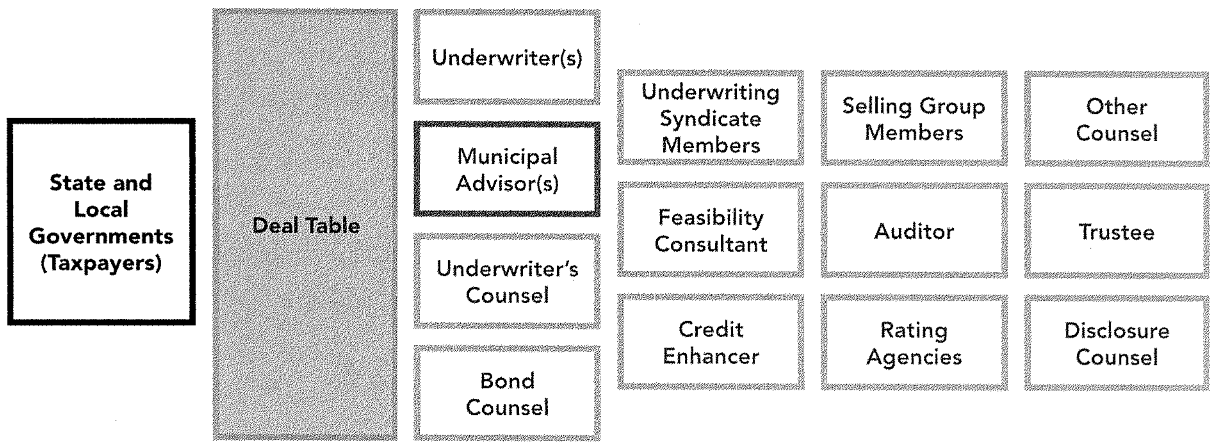
[11] Although in the past these duties arising out of the relationship of trust have not always been well understood, the fact that such relationship exists and gives rise to specific duties has become increasingly clear in recent years, whether through enforcement actions, the enactment of the federal fiduciary duty itself or the extensive discussions regarding fiduciary standards since enactment of the statute. Elimination of the federal fiduciary standard in the statute would not ultimately be successful at reducing the expectation of adherence by municipal advisors to state-based fiduciary obligations owed to state and local governments.

in the context of specific legal proceedings.

Elimination of a federal fiduciary duty for municipal advisors would not change the MSRB's mandate to protect state and local governments. It will continue to fulfill its mission to include the adoption of rules on the advisory activities of municipal advisors for the purpose of, among other things, protecting state and local governments. This mission includes rulemaking authority with respect to standards of fair dealing, conflicts of interest (including pay-to-play activities), professional qualifications, continuing education, supervision, recordkeeping and a range of other areas. The MSRB will, as mandated by Congress, adopt a rigorous, well-balanced set of municipal advisor rules designed to provide the full range of protections that state and local governments, obligated persons, investors and the general public deserve and are entitled to under the Exchange Act. As the Subcommittee wrestles with the issue of how to best fulfill this mission, please carefully consider the vital need for municipal advisors to have the obligation to act in the best interest of their state and local government clients.

I hope that I have provided the Subcommittee with helpful information with respect to your consideration of a federal fiduciary duty for municipal advisors, the merits of scope-based exclusions to the definition of municipal advisor, our overall views on their regulation and the importance of moving forward with implementation of Section 975 of the statute.

Professionals Involved in a Municipal Bond Financing Transaction



The chart illustrates the complexity and number of professionals* involved in a municipal bond financing transaction. In almost every case, compensation of these professionals is contingent on the closing of the bond deal. In the vast majority of cases, state and local government bond issuers are unfamiliar with the mechanics of the financing transaction.

*see reverse for description of responsibilities

Responsibilities of Professionals Involved in a Municipal Financing Transaction

State or Local Government Issuer
Municipal entity that sells its securities to the public.

Underwriter(s) (also known as Senior Manager, Lead Manager or Bookrunner)
Forms a syndicate to distribute securities to the public. The underwriter allocates securities among other firms in the group but is itself generally responsible for the largest share of the issue.

Municipal Advisor
Retained by an issuer in a fiduciary capacity to assist in executing a municipal bond transaction, purchasing a financial product or other activity.

Underwriter's Counsel
Acts as the legal advisor to the underwriter, underwriting syndicate and selling group members.

Bond Counsel
Represents the interests of investors in a bond transaction and issues an opinion as to the legality of the bonds.

Underwriting Syndicate
A group of investment banking firms that purchases a new issue of securities from the issuer and distributes them to investors.

Selling Group
Assists in the distribution of a new issue of securities but does not participate in the profits or liabilities of the underwriting syndicate.

Feasibility Consultant
Writes the feasibility report prepared for revenue bond sales, which is generally included in the preliminary and final official statements.

Credit Enhancers
Companies that provide a substitute for or a support — such as bond insurance or a letter of credit — to enhance an issuer's credit, in exchange for a fee or premium.

Auditor
Is responsible for examining the issuer's financial records and reports, and delivers an opinion on those financial records.

Rating Agencies
Companies that grade securities so as to indicate the quality of the securities for the investors.

Trustee/Paying Agent
An appointed institution that manages assets for the benefit of the bondholders according to the terms of the trust indenture.

Disclosure Counsel/Other Counsel
Takes responsibility for preparation of the preliminary and final official statements. Other counsel may include special tax counsel, bank counsel and borrower's counsel.

//ACLI
Financial Security...for Life.

American Council of Life Insurers (ACLI) Statement for the Record
House Financial Services Committee
Subcommittee on Capital Markets and Government Sponsored Enterprises
"The Impact of the Dodd-Frank Act on Municipal Finance"

July 20, 2012

The American Council of Life Insurers (ACLI) is pleased to submit this statement for the hearing record expressing the concerns of the life insurance industry about a rule proposed by the Securities and Exchange Commission (SEC) establishing a registration program for "municipal advisors." The stated purpose of the proposed rule is to implement Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

The American Council of Life Insurers is a Washington, D.C.-based trade association with more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. ACLI advocates in federal, state and international forums. Its members represent more than 90 percent of the assets and premiums of the U. S. life insurance and annuity industry. In addition to life insurance, annuities and other workplace and individual retirement plans, ACLI members offer long-term care and disability income insurance, and reinsurance. Its public website can be accessed at www.acli.com.

ACLI member companies administer retirement plans established by municipalities for their employees, including defined benefit, defined contribution, 403(b) and 457 plans. As described below, the proposed rule represents a profound and costly change for life insurers, municipalities, and their employees in the regulation of government retirement plans. The proposed rule would layer new municipal advisor regulations onto existing regulatory regimes to which life insurers, broker-dealers, and investment advisers are already subject. This duplication of existing regulation is both unnecessary and counterproductive.

Furthermore, the proposed rule is contrary to Congressional intent and to the plain terms of Section 975 of the Dodd-Frank Act. The SEC has made an overly broad interpretation of Section 975, proposing to apply the municipal advisor registration requirement to broker-dealers marketing insurance contracts that fund government plans and potentially to the investment advisers managing assets underlying those contracts. The stated purpose of this broad application is to implement the Dodd-Frank provision and thereby address a perceived gap in municipal financial transactions.

However, the Dodd-Frank Act did not alter the definition of "municipal securities," which continues to be defined under the Securities Exchange Act of 1934. There is no evidence of Congressional intent to expand the definition of municipal securities to include retirement or similar services provided by life insurers, broker-dealers marketing insurance contracts that fund government plans, or investment advisers managing assets underlying those contracts. To the contrary, Congress specifically intended Section 975 to address the market for municipal securities and previously unregulated market participants and unregulated financial transactions in that space. The delivery and management of government retirement plans were not intended to be covered by Section 975.

In addition, neither the products and services provided by life insurers, nor the broker-dealers and investment advisers described above, represent a regulatory gap needing to be addressed by the proposed rule. Life insurers are subject to extensive product, operational, market conduct, financial condition, and solvency regulation by the states. Variable products offered by life insurers are regulated by the SEC. Broker-dealers affiliated with life insurers are regulated under the Securities Exchange Act of 1934, and investment advisers are regulated under the Investment Advisers Act of 1940. According to the Employee Benefit Research Institute's *Fundamentals of Employee Benefit Programs*, "Constitutional and contractual law guarantees, which may be expressed in state statutes and decisional law, afford members of public employee retirement plans many of the protections granted to members of ERISA-regulated plans by federal statutory law. In fact, it is safe to say that public employees have protection that is comparable with that of private-sector employees today, although from different sources." As a result, there is no compelling reason to add another regulator and regulatory regime in this area.

ACLI welcomes the recognition by SEC Chairman Mary Schapiro that the proposed rule is overly broad. However, definitive action is necessary to prevent added costs or disruptions to the delivery of retirement plans to public employees across the country. ACLI supports the legislation authored by Representative Robert Dold, H.R. 2827, which would clarify the definition of a municipal advisor. ACLI thanks Representative Dold and the Subcommittee for its leadership on this important issue. ACLI encourages the Subcommittee to continue to exercise its oversight authority over the SEC as it engages in any final rulemaking in this area. ACLI believes that the proposed rule should be withdrawn in its entirety and revised in a manner consistent with Congressional intent and the plain terms of Section 975.

Thank you for convening this important hearing and for your consideration of the views of ACLI and its member companies.

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Testimony for the Record

On H.R. 2827

Submitted to the Subcommittee on Capital Markets, U.S. House of Representative, Washington, D.C.

By Colette Irwin-Knott – President, National Association of Independent Public Financial Advisors

July 20, 2012

Introduction

Mr. Chairman and Members of the Subcommittee:

On behalf of the National Association of Independent Public Financial Advisors and its members, we are pleased to submit written testimony for the record in opposition to bill H.R. 2827 – To amend the Securities Exchange Act of 1934 to clarify provisions relating to the regulation of municipal advisors, and for other purposes ("H.R. 2827" or the "Bill"). The National Association of Independent Public Finance Advisors respectfully urges Congress to not pass H.R. 2827. We propose, instead, leaving unchanged those portions of the Securities Exchange Act of 1934 that would be affected by H.R. 2827.

The National Association of Independent Public Finance Advisors ("NAIPFA") was founded in 1990 as a professional organization representing the interests of independent public finance advisory firms who provide public finance advice to municipal entities and obligated persons. Our membership is comprised of thirty-two member firms representing clients on approximately 3,000 bond issues equating to nearly $75 billion in municipal securities issuances annually. These firms are considered "independent" by virtue of their lack of affiliation with any broker, dealer or municipal securities dealer. As distinguished from brokers, dealers, and municipal securities dealers, our member firms are able to offer a wide variety of consulting services to both issuer and obligated persons without the underlying conflicts of interest that accompany these other market participants while performing similar functions.

Background

Prior to the enactment of Section 975 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or the "Act"), any individual, regulated and otherwise, could provide advice to or on behalf of municipal

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entities or obligated persons with respect to municipal financial products or the issuance of municipal securities (including advice with respect to the structure, timing, terms and other similar maters concerning such financial products or issues). This led to the widespread reliance by municipal entities and obligated persons upon the advice they receive from broker-dealers who were free to, and did, act without regard to the interests of these entities when providing advice. In response, Congress determined through their enactment of the Dodd-Frank Act, which thereby amended the Securities and Exchange Act of 1934 (the "Exchange Act"), that all individuals who provide advice to or on behalf of municipal entities or obligated persons with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms and similar matters ("Municipal Advisory Services"), including broker-dealers, should to be classified as "Municipal Advisors" and have accompanying fiduciary duties vis-à-vis the advice they provide to municipal entities or obligated persons. Notably, under the Act, broker-dealers would only be considered Municipal Advisors to the extent that they provide Municipal Advisory Services. In fact, the Act specifically excludes broker-dealers from the definition of Municipal Advisor when the broker-dealer is engaged by a municipal entity or obligated person as an "underwriter" as that term was defined in Section 2(a)(11) of the Exchange Act. In this regard, the Act makes clear that broker-dealers serving as underwriters would be excluded from the definition of Municipal Advisor and corresponding fiduciary responsibilities.

The Act's amendments to the Exchange Act were largely in response to concerns that individuals, some of whom may have already been regulated in one capacity or other, were essentially unregulated with respect to the advice they provided to municipal entities and obligated persons. Prior to enactment of the Dodd-Frank Act, many market participants would provide advice to the issuer with respect to the structure, timing and terms of a securities issuance in order to lead the issuer towards the issuance of a particular kind of security or manner of sale without regard to what may have been in the issuer's best interest. Various broker-dealers acted in this manner to effectively engage in self-dealing; broker-dealers who provided what now would be considered Municipal Advisor Services were under no obligation to provide these services in a manner designed to serve the municipal entity's or obligated person's interest and instead were able to unduly influence these entities into undertaking a course of action designed to benefit the broker-dealer's own interests. In addition, broker-dealers providing Municipal Advisory Services engaged in practices, documented by regulatory actions and court cases, which could be considered inappropriate in light of the reliance placed upon these entities by municipalities and obligated persons, such as:

- Failing to clearly disclose fees charged to municipal entities and obligated persons;
- Charging excessive fees to municipal entities and obligated persons;

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- Pay-to-play arrangements and excessive gift giving to employees and officials of municipal entities or obligated persons;
- Excessive or impermissible political contributions to municipal officials;
- Utilizing and recommending exotic, synthetic or otherwise inappropriate financial products to unsophisticated municipal entities or obligated persons;
- Rigging bidding processes to win business from municipal entities and obligated persons; and
- Recommending the issuance or refinancing of bonds without a justifiable benefit to the municipal entity or obligated person.

We believe that these practices led to unnecessarily high interest rates as well as the issuance of variable rate demand obligations and derivatives by unsophisticated market participants. The issuance of these unsuitable products by municipalities and obligated persons allowed broker-dealers to expand the underwriting fee they obtained upon issuance. These higher rates and fees negatively impacted issuers as well as the taxpayers and ratepayers responsible for making payments on this debt. At the time of enactment, it was hoped that the Dodd-Frank Act would curtail the worst of these abusive practices.

Commentary on H.R. 2872

In essence, H.R. 2827 codifies the environment that existed prior to the enactment of the Dodd-Frank Act in which broker-dealers were given the unfettered ability to influence municipalities and obligated persons without regard to the interests of those entities. The Bill accomplishes this by leaving in place the Act's definition of Municipal Advisor while revising the exclusion from the definition for broker-dealers. The Act, although specifically excluding any broker, dealer, or municipal securities dealers, limited this exclusion to those broker-dealer serving as underwriters as that term is defined in Section 2(a)(11) of the Securities Act of 1933 (the "Securities Act"). By contrast, H.R. 2827 eliminates the limiting language contained within the Dodd-Frank Act and instead creates a broad exclusion from the definition of Municipal Advisor for any broker-dealer by virtue of their role as underwriter.

This revision is extremely troubling as it will essentially put in place a regulatory system whereby the prior offenders are given free reign to return to the abusive practices of the past. As in the past, municipal entities will again rely upon the advice they receive from broker-dealers, which could lead to the same improper self-dealing, and the higher interest rates and fees were which customary in the pre-Dodd-Frank Act environment, all of which will be detrimental to the municipal entities and, ultimately, their taxpayers.

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What is more, the exclusion carved out by H.R. 2827 for broker-dealers is hard to justify in light of the other exclusionary measures of the Dodd-Frank Act as well as the Bill. Shortly after enactment of the Dodd-Frank Act, the Securities and Exchange Commission ("SEC") put forth Release No. 34-63576 – Registration of Municipal Advisors ("Release"). In this Release, the SEC attempted to clarify the provisions of Section 15B(e)(4)(C) of the Exchange Act, which set forth an illustrative list of individuals excluded from the definition of municipal advisor. This section, for all intents and purposes, mirrors that of H.R. 2827, except for those provisions relating to broker-dealers.

In the Release, the SEC clarified the type of advice that can be provided by the various market participants without fear of classification as Municipal Advisor. The Release includes precise unequivocal statements regarding the exclusions contained within § 15B(e)(4)(C) of the Exchange Act, a sampling of which are as follows:

> _Investment Advisers_. Investment advisers were excluded under §15B(e)(4)(C) if the advice they provide falls within the Investment Advisers Act. The SEC went on to state that "a registered investment adviser or an associated person of a registered investment adviser would not have to register as a 'municipal advisor' with respect to the provision of any *investment* advice subject to the Investment Advisers Act." Conversely, an investment adviser "must register [...] as a municipal advisor if the adviser or associated person engages in any municipal advisory activities that would not be investment advice subject to the Investment Advisers Act."

> _Commodity Trading Advisors_. Commodity trading advisors were excluded under §15B(e)(4)(C) if the advice they provide is advice related to swaps, but "a commodity trading advisor [...] must register with the Commission as a municipal advisor if the commodity trading advisor [...] engages in municipal advisory activities that do not include advice related to swaps."

> _Attorneys_. Attorneys were excluded under §15B(e)(4)(C) if they are providing legal advice or if they provide services that are of a traditional legal nature, and are excluded from classification as Municipal Advisor "*unless* the attorney engages in municipal advisory activities."

> _Engineers_. Engineers were excluded under §15B(e)(4)(C) if the advice provided is engineering advice. However, the Commission concluded that the "exclusion does not include circumstances in which the engineer is engaging in municipal advisory activities [...] even if those activities are incidental to the provision of engineering advice."

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> Accountants. Although not specifically excluded under §15B(e)(4)(C), the Commission stated that accountants, like individuals specifically excluded under §15B(e)(4)(C), are exempt if they provide non-municipal advisory services. The SEC noted that some accountants do engage in municipal advisory activities and therefore an exclusion would not be appropriate. However, accountants who provide services, such as "preparing financial statements, auditing financial statements, or issuing letters for underwriters for, or on behalf of, a municipal entity or obligated person," are not engaged in municipal advisory activities and are therefore excluded from the definition of municipal advisor.

When providing Municipal Advisory Services, broker-dealers should be classified as Municipal Advisors and treated no differently under the law than other market participants performing similar functions who would be classified as Municipal Advisors. Like some of the other market participants, broker-dealers are already regulated with respect to particular kinds of conduct, and like other market participants, broker-dealers may have interactions with municipal entities and obligated persons in which advice is provided and relied upon by the municipal entities or obligated persons. However, under H.R. 2827, unlike these other market participants, broker-dealers would not be classified as Municipal Advisors with corresponding fiduciary duties when they provide Municipal Advisory Service.

It is not in the interest of the municipal market, or municipal entities or their taxpayers to create an exclusion for broker-dealers that breaks from the clear delineations put forth by the SEC in connection with the other exclusions contained within §15B(e)(4)(C) of the Exchange Act. That is, every exclusion existing under §15B(e)(4)(C) and those set forth in H.R. 2827, except for the new proposed exclusion for broker-dealers, is inapplicable where the individual provides Municipal Advisory Services. Whereas, the broad exclusion for broker-dealers will open the door for potential improprieties and will allow virtually any individual wishing to escape their fiduciary responsibilities to simply register as a broker, dealer, or municipal securities dealer, including, financial advisors who otherwise would clearly fall within the definition of Municipal Advisor. As such, NAIPFA is very concerned that this rule will undermine each and every protection put in place by the Dodd-Frank Act as individuals will be able to circumvent the fiduciary duties that otherwise would be owed to municipal entities.

In addition, the revisions outlined in H.R. 2827 are unwarranted given that the regulations set to be promulgated as a result of the Act have either not been enacted or have yet to be written. As such, the proposed adoption of H.R. 2827 is premature as the full impact, or lack thereof, of the Dodd-Frank Act and corresponding regulations has yet to be felt. Therefore, at this time, NAIPFA would urge restraint on the part of Congress to allow for

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the full implementation of the Dodd-Frank Act. In turn, this will allow for a more full and accurate analysis of the impact of the Act as well as the potential benefits or ramifications of adopting a bill such as H.R. 2827.

Enforcement

The delineations set forth in the Dodd-Frank Act and the Release with respect to the exclusions from the definition of Municipal Advisor, allow for proper enforcement of the law by virtue of individuals' obtainment of fiduciary duties. In other words, as enacted, the Act provides for the SEC or other enforcement agency to hold individuals accountable when they act inappropriately or without the requisite knowledge or experience when providing Municipal Advisory Services. Under H.R. 2827, no similar mechanism exists with respect to broker-dealers; broker-dealers are excluded from the definition of Municipal Advisor regardless of their activities. This Bill throws into question whether a broker-dealer can ever be held accountable, let alone obtain fiduciary responsibilities, as a result of the advice it provides to a municipal entity or obligated person. This has in the past and, upon passage of H.R. 2827, will again in the future lead to abuses which will ultimately be detrimental to the municipal market, municipal entities and their taxpayers.

Further, in light of the recent revelations with respect to the massive trading losses at J.P. Morgan Chase and the Barclays Capital LIBOR scandal, now more than ever, our Country needs to have in place strong regulatory measures to curtail the abuses and harmful business practices of the past while, on a going forward basis, protecting the interests of investors and taxpayers.

Conclusion

NAIPFA does not support the passage of H.R. 2827 and would instead encourage Congress to allow for the full implementation of the Dodd-Frank Act prior to enacting any revisionary measures relating thereto. Furthermore, NAIPFA is concerned that the enactment of H.R. 2827 will give immunity to broker-dealers to freely engage in the practices of the past that led to one of the worst financial crises in this Country's history. This tacit endorsement of the past will be detrimental to not only municipal entities and their tax/ratepayers, but also the Country as a whole. As such, NAIPFA urges Congress to reject H.R. 2827 and allow the provisions of the Dodd-Frank Act relating to Municipal Advisors to remain unchanged at this time.

SPENCER BACHUS, AL, CHAIRMAN

United States House of Representatives
Committee on Financial Services
Washington, DC 20515

BARNEY FRANK, MA, RANKING MEMBER

July 2, 2012

Honorable Mary L. Schapiro
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Schapiro:

I write to express serious concerns about the Commission's proposed rule on municipal advisor registration. The proposed rule could be read to result in a registration requirement in cases where a bank is simply engaged in traditional banking activities. The Wall Street Reform Act clearly did not intend that result, nor does the statutory language support it. I appreciate your comments before the Financial Services Committee that the final rule should be tailored to exclude such "traditional banking business" activities. I expect the final rule to correct that problem.

I am particularly concerned that the Commission has not adequately differentiated between advising a municipality about how to invest the proceeds of an issuance and merely offering a municipality a menu of products from which to choose. In my view, there are two circumstances in which a bank should be subject to the new registration requirement: if the bank actually structures the issuance, as typically demonstrated by the bank's name on the prospectus, or if it clearly provides investment advice and actively directs the municipality to a specific product or products.

But Congress did not intend that simply offering lists of available investment options to a municipality should be considered "advice." Municipalities often solicit requests for proposals (RFPs) to better understand the investment options for their securities' proceeds. Banks often respond to such requests with a set of financial product choices for the municipality. Such responses are, and should be understood by the Commission to be, "traditional banking business" and not the provision of investment advice. In such cases, the bank is not telling the municipality how it should invest, and should not be required to register.

I am also concerned that the rule not place unnecessary new compliance burdens on small and medium-sized institutions. The distinctions drawn should be sufficiently precise and clear to allow banks to readily demonstrate compliance. The Commission should not, for example, adopt a rule that requires bank personnel to monitor lists of municipal issuers (which may be far broader than just city governments) or require bank personnel to inquire as to the sources of funds for deposits coming from such issuers. It would be extremely difficult and burdensome for banks to demonstrate compliance with such requirements, and the statute did not contemplate their being imposed.

Barney Frank

BARNEY FRANK
Ranking Member

Spelman College

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BEVERLY DANIEL TATUM, Ph.D.
President

July 9, 2012

The Honorable Maxine Waters
2344 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Re: Registration of Municipal Advisors under Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Congresswoman Waters:

As president of Spelman College, I want to thank you for your steadfast commitment to the mission of historically Black colleges and universities and your continuing leadership in Washington. As you know, in recent years, there are a number of HBCUs that have been struggling to survive while there are others, like Spelman, that continue to thrive. A study of those who are thriving will reveal the presence of a strong governing Board, a Board that not only makes wise choices in terms of selecting presidential leadership but also a Board that takes seriously its obligation to provide fiscal oversight as a governing body. It is hard to find really talented Board members willing to devote the time and energy needed – as unpaid volunteers – to provide effective governance, yet those are exactly the kind of Board members HBCUs need.

I am writing to you today because the proposed rule regarding the registration of municipal advisors currently under consideration by the SEC will make it much more difficult for institutions like mine to recruit and retain the Board members that make the difference between surviving and thriving. While I appreciate the efforts of the SEC to regulate those professional advisors who sell their financial advice in the marketplace, I am concerned about the blanket application of such regulation to non-profit governing boards. Such overreach will have unintended consequences for colleges and universities like my own who rely upon the unpaid volunteer service of trustees to provide fiduciary oversight as part of our governance structure.

As you know, Spelman College is the global leader in the education of women of African descent. One of only two historically Black colleges for women, Spelman has flourished in an increasingly competitive higher education context in part because we have been able to attract highly accomplished men and women to our Board of Trustees who have been willing to give countless hours of their time and talent, without compensation, to ensure the well-being of the College. As defined by our by-laws, "The Board of Trustees shall oversee and control the property, business and affairs of Spelman College." While the role of the Board of Trustees is one of overall governance rather than one of active day-to-day administration (a responsibility delegated to the president of the institution), the Board is indeed a decision-making body that has responsibility for the fiscal health of the institution. Trustees are not "advisors," they are decision-makers, and they take on that responsibility out of a love for the mission of the institution, not for personal gain.

Indeed, our regional accreditation requires that we clearly delineate a conflict of interest policy for our trustees as well as officers of the College, which explicitly forbids behavior which might be construed as in self-interest rather than in the interest of the institution. Effective functioning of a college or university Board is often the difference between those institutions that thrive and those that flounder. That said, the skill level and sophistication of the Board members is a critical factor in the capacity to function effectively. Requiring unpaid volunteers like these to register with the SEC as a condition of their volunteer service will surely make it more difficult for us to recruit the kind of thoughtful and accomplished trustees we need, particularly those with financial expertise. To the extent that colleges and universities would have to provide administrative support to the Board members as they document their compliance with the SEC regulations, this regulation threatens to *increase* administrative costs at a time when we are trying to contain overhead and reduce costs to students.

I am aware that the Association of Governing Boards of Universities and Colleges (AGB), of which Spelman College is a member, has suggested that the proposed rule be modified to specifically exclude from the definition of municipal advisor the following categories of individuals:

> Any member of the governing board of a municipal entity acting in their official capacity;
> Any member of the governing board of an obligated person acting in their official capacity;
> Any employee of a municipal entity acting within the authorized scope of their employment;
> Any employee of an obligated person acting within the authorized scope of their employment.

I would like to express my ardent support for this suggested modification. I believe that providing explicit clarification regarding to whom the rule applies, and perhaps most importantly, to whom it does not apply, will help us avoid the unintended consequence of harming the governance of colleges and universities across the country at a time when we need strong educational institutions more than ever.

I have expressed this point of view in a letter to Ms. Elizabeth Murphy, Secretary of the U.S. Securities and Exchange Commission, and to Representative Scott Garrett, Chair of the Subcommittee on Capital Markets and Government Sponsored Enterprises. Given your role on Financial Services, I thought it especially important that you knew how critically important this issue is to the long-term health of institutions like Spelman College. If I can provide any additional insight into this issue from the perspective of colleges and universities, please do not hesitate to contact me. As always, I appreciate your advocacy on behalf of our educational institutions.

Thank you for your consideration of these concerns and the suggested AGB modification of the language.

Respectfully submitted,

Beverly Daniel Tatum

Beverly Daniel Tatum, Ph.D.
President

Response of Alan D. Polsky

I believe that the MSRB's suggested "scope-based" approach to the exclusions from the definition of municipal advisor for professionals otherwise subject to different legal or professional standards would eliminate the need for courts to determine whether the federal fiduciary duty for municipal advisors could potentially conflict with such other standards of care. For example, excluding a registered investment adviser from the definition of municipal advisor insofar as such investment adviser is engaging in investment advisory activities subject to federal or state duties would eliminate any potential conflict between the federal municipal advisor fiduciary duty and such other federal or state duties, while continuing to treat such investment adviser as a municipal advisor to the extent of its municipal advisory activities outside the scope of its federal or state-regulated investment advisory services also would not give rise to any such conflict.