Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance

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Chairman Frank, Ranking Member Bachus, and members of the committee, I am Martha Haines. I head the Office of Municipal Securities in the Division of Trading and Markets, which coordinates the Securities and Exchange Commission's municipal securities activities, advises the Commission on policy matters relating to the municipal bond market and provides technical assistance in the development and implementation of SEC initiatives in the municipal securities area. The Division also administers the SEC's rules applicable to credit rating agencies registered as nationally recognized statistical rating organizations ("NRSROs"). I appreciate the opportunity to testify before the Committee today on behalf of the SEC.

Municipal Financial Advisors

<u>Introduction</u>

The question of whether financial advisors to municipal issuers and conduit borrowers should be regulated is a topic of significant interest to the Commission. We have been concerned about the observed and reported conduct of some municipal financial advisors, including "pay to play" practices, undisclosed conflicts of interest, advice rendered by financial advisors without adequate training or qualifications, and failure to place the duty of loyalty to their clients ahead of their own interests. However, the Commission's current statutory authority limits our ability to address these concerns adequately.

The Commission believes an expansion of its authority over the conduct of municipal financial advisors would be appropriate to address these concerns. The Municipal Advisers Regulation Act would provide tools that would help address the problems we have observed concerning financial advisors who advise municipal issuers and conduit borrowers concerning their securities offerings, transactions in swaps and other derivative products intended to hedge risk, and the investment of bond proceeds. In particular, we support the Act's clarification of the specific duty of care that a financial advisor owes to its client.

Today, I would like to describe our present jurisdiction to clarify the activities of financial advisors that may subject them to regulation as broker-dealers, the reasons the Commission supports an expansion of our authority in this area, and comment on the Fair Municipal Bond Regulation Act and Municipal Advisers Regulation Act recently introduced by Chairman Frank.

Background – Current Scope of Commission Authority

Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act of 1933 ("Securities Act"), and system of periodic reporting under the Securities Exchange Act of 1934 ("Exchange Act"). However, it did not exempt transactions in municipal securities from the coverage of the antifraud provisions of section 17(a) of the Securities Act, section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. These antifraud provisions prohibit any person, including municipal issuers and brokers, dealers and municipal securities dealers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security. In addition, brokers, dealers and municipal securities dealers are subject to regulations adopted by the Commission, including those regulations adopted to define and prevent fraud. Municipal securities dealers are also subject to rules promulgated by the Municipal Securities Rulemaking Board ("MSRB").

Financial Advisors who are Broker-Dealers

The Commission and the MSRB have regulatory authority over municipal financial advisors who are registered broker-dealers. In contrast, financial advisors who are not broker-dealers currently are unregulated. To the extent that these persons act as “brokers” within the meaning of the Exchange Act, however, they are currently required to register and subject to Commission regulation and oversight.

Under the Exchange Act, a “broker” is broadly defined as any person engaged in the business of effecting transactions in securities for the account of others. Determining whether a person is a broker within the meaning of this definition is a fact-specific inquiry. The Commission and the courts generally look at the activities that the person actually performs to determine whether that person is participating at key points in a securities transaction. These key points typically include solicitation, negotiation, or execution of the transaction, and/or receipt of compensation that is dependent upon, or related to, the outcome or size of the transaction or deal, or receipt of other transaction-related compensation.

Notably, because the activities and compensation structure of municipal financial advisors vary widely, even a broad reading of the Commission’s existing regulatory authority over brokers is likely to leave many municipal financial advisors unregulated. Legislation would be required to ensure that municipal financial advisors are regulated.

Investment Advisers

The Investment Advisers Act of 1940 ("Advisers Act") generally does not cover the activities of municipal financial advisors because they do not fall within the definition of investment adviser. Under the Advisers Act, an "investment adviser" is a person who, for compensation, is in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[1] Municipal financial advisors, in contrast, are generally in the business of providing municipalities with a range of services concerning the structuring, timing and issuance of their bond offerings. Among other things, municipal financial advisors assist states and municipalities in preparing bond-related documents and in selecting and negotiating with underwriters. They may also make recommendations about the investment of temporarily idle proceeds of a bond issue or monitor the performance of the issue.[2] In 2000, our Division of Investment Management issued a Staff Legal Bulletin to clarify the circumstances under which the staff believes financial advisors (a) may be investment advisers, and (b) may give advice to issuers of municipal securities

[1] Section 202(a)(11) of the Investment Advisers Act of 1940.

[2] *See In the Matter of O'Brien Partners, Inc.*, Advisers Act Release No. 1772 (Oct. 27, 1998) (the Commission found in a settled proceeding that a financial advisor acted as an investment adviser by advising municipal clients to invest their bond offering proceeds in securities, including repurchase agreements and guaranteed investment contracts ("GICs"), and by receiving compensation for providing that advice); *In The Matter of Rauscher Pierce Refsnes, Inc.*, et al., Advisers Act Release No. 1863 (April 6, 2000) (the Commission found in a settled proceeding that a financial advisor acted as an investment adviser by advising its client to invest bond offering proceeds in securities, including a forward supply contract and a GIC, and by receiving compensation for providing that advice).

regarding the investment of offering proceeds without being deemed to be investment advisers for purpose of the Advisers Act.[3]

Even if all municipal financial advisors were to meet the Advisers Act's definition of "investment adviser," most would be exempt from Commission registration and oversight because, under the Advisers Act, an investment adviser that has less than $25 million of assets under management registers with state securities authorities rather than the Commission.[4] Municipal financial advisors typically do not manage client assets. As a result, they would not be subject to regulation by the Commission even if they were deemed to be investment advisers for the purpose of the Advisers Act.

Antifraud Authority and Enforcement Actions

Municipal financial advisors are, of course, subject to the antifraud provisions of the securities laws to the same extent as any party who participates in a securities offering or transaction. The Commission has brought over 20 enforcement actions against municipal financial advisors, including several against financial advisors who were not broker-dealers. For example, the Commission found in a settled proceeding that a financial advisor did not adequately disclose to an issuer of advance refunding bonds a payment arrangement under which the financial advisor received a $104,000 payment in

[3] *See* Division of Investment Management Staff Legal Bulletin No. 11 (Sept. 19, 2000), available at http://www.sec.gov/interps/legal/slbim11.htm (a financial advisor that receives special compensation for providing investment advice with respect to the purchase or sale of securities or that provides specific advice about the investment of temporarily idle bond proceeds routinely or with some regularity is in the business of providing investment advice and therefore is an investment adviser under the Advisers Act).

[4] Advisers Act section 203A. Note, however, that the anti-fraud provisions of the Advisers Act apply to all investment advisers regardless of whether an investment adviser is registered. *See* Advisers Act section 206.

return for selecting a particular broker-dealer to sell government securities to the issuer.[5] This is demonstrative of one type of conflict of interest which a financial advisor may have. In other cases financial advisors have failed to disclose fees paid to consultants[6] or made material errors and omissions in preparing offering documents.[7]

Harmful activities of market participants who are not subject to Commission registration and oversight are more difficult to discover. Without the opportunity that reporting, inspection and examination provide, it is difficult to monitor these activities and keep apprised of emerging practices. In addition, the antifraud provisions are an after-the-fact remedy. Thus, antifraud enforcement actions cannot provide the kind of specific and nuanced guidance or cover the broad scope of activities that regulatory authority under the proposed legislation would make possible.

Possible Regulation/Areas of Concern

It is important to keep in mind the municipal securities market's unique importance because of the governmental nature of the issuers and the public nature of the projects financed. The impact on the functioning of this market that may result from poor advice provided, or misleading disclosure documents prepared, by unqualified municipal financial advisors, participation by financial advisors with conflicts of interest, or those engaged in pay to play activities, for example, can indirectly affect the daily lives of Americans. Furthermore, bad or self serving advice may have long term consequences for

[5] *In the Matter of John S. Reger II, and Business & Financial Advisors, Inc.*, Securities Act Release No. 7973, A.P. File No. 3-10221 (April 23, 2001) (settled proceeding).

[6] *In the Matter of Wheat, First Securities, Inc. f/k/a First Union Capital Markets Corp. and Teressa L. Cawley*, Exchange Act Release No. 48378, A.P. File Nos. 3-9688 and 3-9794 (August 20, 2003) (settled proceeding).

[7] *In the Matter of County of Nevada, City of Ione, Wasco Public Financing Authority, Virginia Horler, and William McKay*, A.P File No. 3-9542, Initial Decisions Release No. 153 (October 29, 1999).

an issuer’s financial condition and ability to access the capital markets. Authorizing the Commission to require financial advisors engaged in the activities covered by the proposed legislation to have minimum qualifications, follow conduct rules designed to ensure that they deal fairly with their clients, eliminate “pay to play” activities, and avoid or disclose conflicts of interest would help prevent harm to issuers, taxpayers and citizens dependent on the infrastructure financed with municipal securities – for clean water, schools, roads, airports, fire stations and other essential public facilities – in addition to protecting the interests of investors. Of course, new regulations would impose some burdens on financial advisors, which could potentially be passed along to issuers through higher fees.

Standard of Care and Professional Standards

Presently, there are no professional standards or qualifications for financial advisors. The establishment of minimum professional standards for financial advisors and clarification of their standard of care towards their clients could help to raise the quality of the advice given by financial advisors. This is important because many municipal issuers do not access the market often and are highly dependent on their advisors regarding securities offerings. Of course, large, frequent issuers who may be more sophisticated may also benefit from obtaining advice from advisors that meet established professional standards.

The current situation may result in an issuer entering into transactions that are not in the best interest of either the issuer or investors. The quality of, and disclosure related to, the feasibility studies and asset appraisals upon which the economic justification for, and repayment risk of, some bond issues is based is very important both to investors and issuers. It is vital for the financial advisor “experts” who prepare such studies and reports to be qualified and not be subject to conflicts of interest, and for the assumptions forming the basis for projections to be reasonable. Furthermore, financial advisors generally have significant input into the content of issuer disclosure documents. Sometimes they prepare the entire official statement for the issuer. While this initially may appear to be a benefit for issuers, because financial advisors often disclaim responsibility for offering documents, they may be able to avoid responsibility for misleading or inadequate disclosure.[8] Regulations designed to ensure that municipal financial advisors have an understanding of the standards of the securities laws and require them to take responsibility commensurate with their activities could help improve disclosure to investors, prevent fraud and protect both investors and issuers.

Presently the duty of care that a financial advisor owes to its client is established by state laws, which vary widely. Although the case law of some states impose fiduciary duties on financial advisors, the standard of care required of financial advisors is not always clear. There are a number of benefits that could flow from consistent application of a fiduciary standard of care. Clarification that municipal financial advisors are fiduciaries should make uniform and standardize the level of care and duty of loyalty they are obligated to provide to clients, help eliminate conflicts of interest and reduce issuer, investor and regulatory confusion or ambiguity about the responsibilities of financial advisors.

[8] Public entities that issue securities are primarily liable for the content of their disclosure documents and are subject to prescriptions under the federal securities laws against false and misleading information in their disclosure documents. *See* Report under Section 21(a) of the Exchange Act. *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors.*, Exchange Act Release No. 36761 (January 24, 1996).

Conflicts of Interest

The SEC has recognized for many years that increased attention needs to be directed at disclosure of potential conflicts of interest and material financial relationships among municipal issuers, advisers and underwriters, including those arising from political contributions.[9] Such conflicts can undermine the integrity of the marketplace.

In addition, secret payments made to financial advisors with funds that would otherwise have gone to the issuer and other undisclosed conflicts of interest on the part of financial advisors may even affect the issuer's credit quality. For example, a financial advisor might advise an issuer to structure an offering in a particular way (or not object to a structure proposed by another party) which is not in the issuer's best interest in order that the financial advisor may receive payments from a third party, such as the provider of a swap or guaranteed investment contract. Such undisclosed conflicts of interest are of importance to investors.

Thus, an explicit requirement that financial advisors disclose conflicts of interest and payments to or from third parties in connection with a municipal securities offering would be a significant benefit to both investors and issuers.[10]

Pay to Play Activities

Although broker-dealers who serve as financial advisors are subject to MSRB Rule G-37 regarding political contributions, independent financial advisors are not. Broker-dealers maintain that this creates an unlevel playing field when they seek

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[9]See, e.g., Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others (Interpretive Release Regarding Disclosure Obligations in the Municipal Securities Market), Securities Exchange Act Release No. 33741 (March 9, 1994), 59 FR 12748 (March 17, 1994).

[10] See, e.g., *IRS Turns Its Attention to Swap Fees: Excessive Charges A Growing Concern*, The Bond Buyer, August 18, 2005.

financial advisory work because financial advisors who are not broker-dealers are able to make political contributions to issuer officials without jeopardizing their ability to serve as financial advisor to that entity. However, broker-dealers who make political contributions to issuer officials are limited by MSRB G-37 in their ability to do business with that issuer. More importantly, however, “pay-to-play” may result in an unqualified financial advisor being chosen because of his political contributions. Serious concerns arise if issuers were to select advisors based on political, rather than objective, standards. Market integrity is a key objective of the securities laws and is critical in order to provide investor protection and maintaining confidence in the municipal market.

Summary

In sum, a number of issues concerning financial advisors, including their professional qualifications, standard of care, conflicts of interest and pay to play activities necessitate active consideration of statutory change. Granting regulatory authority over the activities of municipal financial advisors to the SEC would significantly benefit issuers and investors alike.

Credit Ratings of Municipal Bond Issues

The municipal markets have become much larger, more diverse and more complex in recent years. There are over $2.6 trillion of municipal securities outstanding, and more than $391 billion of new bonds and notes were issued last year. Daily trading volume in 2008 exceeded $19 billion. [11]

Individuals are significant investors in the municipal securities market, accounting for over one-third of the direct holdings of municipal securities, and that is not counting

[11] Source: SIFMA

their indirect holdings through mutual funds, money market funds, and closed end funds, which account for about another third of the market.

To the extent they provide meaningful information that assists investors, counterparties, and lenders in deciding how to allocate capital or whether to enter into a transaction, credit ratings can play an important role in a well functioning financial market, including the market for municipal securities. While a credit rating should never be the sole basis for making these decisions, the credit rating agencies develop quantitative and qualitative methodologies for assessing credit risk that can produce a useful data point to inform the decision-making of market participants. Consequently, investors and other users of credit ratings expect credit rating agencies to rate obligors, securities and money market instruments in a manner that provides a reliable and unbiased assessment of credit risk.

The Congress addressed the role that credit rating agencies play in the financial markets by enacting the Credit Rating Agency Reform Act of 2006 (Rating Agency Act). This statute was designed to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. The Rating Agency Act, among other things, defined the term nationally recognized statistical rating organization ("NRSRO"); specified the minimum amount of information a credit rating agency must furnish to the SEC to apply for registration and, if granted registration, disclose to the public; required NRSROs to disclose information about the conflicts of interest inherent in business models and to establish procedures to manage conflicts of interest and address the handling of material non-public information; and provided the SEC with exclusive authority to implement registration, recordkeeping, financial reporting and oversight rules with respect to NRSROs, and gave the Commission authority to require the disclosure and management of conflicts, and the authority to prohibit such conflicts. It also gave the SEC the authority to examine NRSROs for, and enforce compliance with, applicable law. At the same time, the Rating Agency Act prohibited the SEC from regulating the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings.

The operative provisions of the Rating Agency Act were implemented through the Commission's adoption in June 2007 of a series of rules putting in place a registration and oversight program for NRSROs. The initial round of rulemaking established requirements governing NRSRO registration, disclosure, recordkeeping, annual reporting, procedures to prevent the misuse of material non-public information, and procedures to disclose and manage conflicts of interest. The new rules also established prohibitions against engaging in certain activities that are conflicts of interest or are unfair, abusive or coercive.

The first credit rating agencies were registered as NRSROs in September 2007. At that time, the SEC began a staff examination of the three credit rating agencies – now NRSROs – most active in rating structured financial products linked to subprime mortgage securities. On July 8, 2008, the SEC released findings from these staff examinations that noted significant weaknesses in rating practices and the need for remedial action by the firms to provide meaningful ratings and the necessary levels of disclosure to investors. In particular, the SEC staff's examinations found that some NRSROs appear to have struggled with the increase in the number and complexity of subprime residential mortgage backed securities ("RMBS") and collateralized debt obligation ("CDO") deals. The examinations uncovered that these NRSROs did not have written comprehensive procedures for rating RMBS and CDOs. Furthermore, significant aspects of the rating process were not always disclosed or even documented by the firms.

In February 2009, the SEC adopted a second round of rulemaking to address concerns raised by the role NRSROs played in the events leading to the current credit crisis. These new measures:

- Require NRSROs to publish performance statistics for one, three, and ten years within each rating category in a way that facilitates comparison with their competitors in the industry. Performance statistics for the rating category encompassing government securities, municipal securities, and foreign government securities, must be further divided into three classes: sovereign debt, United States public finance and international public finance.
- Require disclosure by NRSROs of the way they rely on the due diligence of others to verify the assets underlying a structured product.
- Require NRSROs to disclose how frequently credit ratings are reviewed; whether different models are used for ratings surveillance than for initial ratings; and whether changes made to models are applied retroactively to existing ratings.
- Require NRSROs to make publicly available in Extensible Business Reporting Language ("XBRL") format a random sample of 10% of their issuer-paid credit ratings and their histories for each class of issuer-paid credit rating for which the NRSRO is registered and has issued 500 or more ratings.

- Require NRSROs to make and retain records of all rating actions related to a current rating from the initial rating to the current rating.
- Require NRSROs to document the rationale for any significant out-of-model adjustments used in determining a credit rating whenever a quantitative model is a substantial component of the credit rating process.
- Require NRSROs to retain records of any complaints regarding the performance of a credit analyst in determining, maintaining, monitoring, changing, or withdrawing a credit rating.
- Require NRSROs to provide the Commission with an annual report of the number of ratings actions they took in each ratings class for which they are registered as an NRSRO.
- Prohibit NRSROs from structuring the same products that they rate.
- Prohibit analysts who participate in determining credit ratings from negotiating the fees that issuers pay to be rated.
- Prohibit gifts from those who receive ratings to those who rate them, in any amount over $25.

In enacting the Rating Agency Act and giving the SEC authority to regulate NRSROs, the Congress acted in response to concerns that policy makers, regulators, and market participants raised about the reliability of ratings and the rating process. The substantial number of downgrades of mortgage-linked debt securities has contributed significantly to a lack of confidence in the accuracy of NRSRO ratings. This has been a factor in the broader dislocation of the credit markets, which has impacted municipal issuers.

Currently, there are ten NRSROs. Of these firms, eight have been granted registration in the class of credit rating that includes rating municipal securities. Three of these NRSROs, Moody's Investor Services, Inc. ("Moody's), Standard & Poor's Rating Services ("S&P") and Fitch, Inc. ("Fitch") account for over 99% of the ratings outstanding in this class of ratings. All three NRSROs have noted that historical defaults on municipal securities have been lower than comparably rated corporate or sovereign securities. For example, Moody's has stated that a municipal obligation rated 'A3'on Moody's municipal scale could be rated in a range between 'A1' and 'AA1' on its global scale.[12] According to S&P's U.S municipal ratings default study, S&P's public finance ratings have been significantly more stable than its corporate ratings.[13] Fitch has stated that a recalibration of municipal ratings so they denote a comparable level of credit risk as ratings in its international rating scale for corporate, sovereign and other entities would result in an upgrade of up to two notches for general obligation or senior revenue bonds of issuers rated between 'BBB' and 'A' inclusive.[14]

Some municipal issuers argue that the use by NRSROs of the same symbols to rate municipal and corporate bonds but different definitions for comparable rating categories results in the municipal bonds they issue being rated lower than corporate bonds with an equivalent risk of default. They believe that this raises their financing

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[12] See, The U.S. Municipal Bond Rating Scale: Mapping to the Global Rating Scale and Assigning Global Scale Ratings to Municipal Obligations, Moody's Investor Services, Inc. - March, 2007.

[13] See, U.S. Municipal Rating Transitions and Defaults, 1986-2009, Standard and Poor's – March 11, 2009.

[14] See, Exposure Draft: Reassessment of Municipal Ratings Framework, Fitch Ratings Special Report – July 31, 2008.

costs in terms of the interest they must pay and the need to purchase wrap insurance to have their bonds be highly rated. Some investors, however, argue that the use of common symbols but different definitions is a useful way to distinguish the relative financial strength of municipal issuers since defaults of rated municipal bonds are rare due to contingent factors such as sovereign support. They contend that using a common set of rating category definitions would cause most rated municipal bonds to be slotted into one of the two highest rating categories making it more difficult to assess the individual merits of a bond.

The Municipal Bond Fairness Act, if adopted by the Congress, would mandate that the SEC require NRSROs to establish, maintain, and enforce written policies and procedures designed: (1) to establish and maintain credit ratings with respect to securities and money market instruments designed to assess the risk that investors in securities and money market instruments may not receive payment in accordance with the terms of issuance of such securities and instruments; (2) to define clearly any rating symbol used by that organization; and (3) to apply such rating symbol in a consistent manner for all types of securities and money market instruments. The bill would permit NRSROs to determine "complementary" ratings that assess the likelihood that conditions other than an issuer's failure to make payments to a bondholder or creditor in accordance with documented terms might arise. In this case, the NRSRO would be required to use a different rating symbol. Finally, the bill would require the SEC to establish performance measures to consider whether to initiate a review of whether an NRSRO was adhering to its stated procedures and methodologies for determining credit ratings.

The SEC staff stands ready to provide technical assistance on the bill if that would be useful to the committee. Thank you again for providing us with an opportunity to testify about these two bills now pending before this Committee.