October 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act Mandates Stronger Oversight of the Municipal Securities Market

Many state and local governments have been adversely affected by the financial crisis and an inadequate regulatory environment. Among other abuses, financial advisors to municipalities – while exempt from regulation – were involved in “pay-to-play” scandals and recommended unsuitable investments to small municipalities. These irresponsible actions negatively impacted American families and businesses, for example, by harming the municipalities’ financial health – which can lead to job losses and impose higher costs on taxpayers and their communities. One of the lessons learned from the recent financial crisis is that states and other municipalities need stronger protections from abusive investment practices.

The historic Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”), which President Obama signed into law in July 2010, offers such protections. It will increase transparency and accountability in the municipal bond market as well as put certain safeguards in place to protect states and municipalities that participate in the derivatives market. These protections will help states and municipalities access capital markets and strengthen the financial system.

Stronger Oversight of the Municipal Securities Market Will Benefit the Overall Financial System

- **The municipal securities market affects the lives of every American and the business of every company in the United States:** Whether you use municipal facilities that are financed by bonds, or you're an investor who has municipals in your portfolio, or you're a taxpayer who pays higher bills when municipal finance isn't conducted properly, these protections will help.
- **The overall size of the municipal securities market is enormous:** The current amount of municipal bonds outstanding is estimated to be nearly $2.8 trillion and more than $391 billion of new bonds and notes were issued in 2008.
  - When the federal securities laws were enacted more than 70 years ago, the municipal securities market was relatively small and it was dominated by institutional investors.
  - Today's municipal securities market is particularly favored by individual investors. Fully 36 percent of all municipal securities are owned directly by households, and up to another one-third of the total municipal securities market is held indirectly through money market funds, mutual funds and closed-end funds.
- **The municipal securities market experienced the same proliferation of innovation and financial engineering as the rest of the world’s capital markets in the last two decades:**
  - Municipalities frequently engage in complex derivative transactions and which were then securitized. While the use of derivatives may provide important benefits to municipalities, such as the ability to reduce borrowing costs and hedge or manage interest rate risk, they also pose dangers.
  - The Act, for the first time, ensures that when municipalities use highly sophisticated and often opaque financial products, the financial intermediaries advising them, such as independent financial advisors and swap dealers, are appropriately regulated.

The Act Promotes Greater Transparency and Strengthens Regulatory Oversight in the Municipal Securities Market

- **Registration and regulation of municipal advisors:** The Act, for the first time, subjects advisors that provide advice to municipalities to registration with and regulation by the Securities and Exchange Commission (SEC) as well as to rules issued by the Municipal Securities Rulemaking Board (the MSRB).

- **Strengthened MSRB, including greater independence:** The Act requires the MSRB to adopt rules governing the conduct of municipal advisors, including professional standards. To better protect investors in the municipal securities market, a majority of the MSRB members must be independent of municipal securities dealers, municipal securities brokers, and municipal advisors, brokers and dealers, and must include one public member that represents institutional or retail investors and one public member that has experience in the municipal industry and one public member that represents municipalities.
- **New Office of Municipal Securities ("the Office"):** The Office will administer the SEC's rules governing municipal securities brokers, dealers, advisors, investors, and issuers. The Director of the Office will report to the SEC Chairman, significantly improving accountability for regulatory oversight of the municipal securities market.

Municipal Issuers Have Stronger Protections against Abusive Practices in the Derivatives Market

- **Much needed protections:** The municipal securities market has evolved from a market in which states and municipalities offered straight-forward, simple, fixed rate bonds to finance specific projects into a market that uses complex derivative products. Some municipal issuers may have been misled into entering in derivatives transactions where the risks were not fully or adequately disclosed. The Act gives municipal issuers special fiduciary protections from abusive sales practices.
- **New fiduciary standard of care for municipal advisors:** The Act, for the first time, imposes a fiduciary duty on municipal advisors that advise state and local governments (including advice given to municipal entities regarding swaps and other derivatives), requiring the municipal adviser to act in the best interests of the municipal entities they represent.
- **Greater qualification standards for participation in the over-the-counter derivatives markets:** Generally, the Act requires swaps to be traded on an exchange unless the counterparty is an "eligible contract participant." A municipal counterparty qualifies for this exemption if it has $50 million in discretionary investments (increased from $25 million) or the transaction is entered into with a regulated financial institution, such as a bank or broker-dealer.
- **Higher standard of care for swap dealers dealing with municipalities:** The Act requires the Commodity Futures Trading Commission to write rules governing swap dealers that enter into swaps with "special entities," which include states, localities, and pension funds.

The Act Requires the SEC to Adopt Rules Concerning Universal Credit Rating Standards

- **Universal Credit Rating Standards:** Historically, given differences in credit rating standards, municipal securities have had lower ratings than corporate bonds, even though municipal securities have had lower rates of default. The Act requires credit rating agencies to apply consistent rating standards for all types of securities, including municipal and corporate bonds. These new standards may enable some institutional investors, such as mutual funds, to participate more actively in the municipal securities market.

The Act Calls for Continued Study and Examination of the Municipal Securities Markets

- **US Government Accountability Office (GAO) Studies:** The GAO is required by the Act to study the adequacy of disclosure made by municipalities that issue securities and to review the municipal securities markets generally, which could lead to more reforms:
  - The Act requires the GAO to study the potential benefit of enhanced municipal issuer disclosure, and the repeal of the Tower Amendment, which prohibits the SEC and the MSRB from requiring a municipal securities issuer to register before the sale of municipal securities.
  - The Act requires the GAO to study the municipal securities markets, including an analysis of the mechanisms for trading, quality of trade executions, market transparency and related issues.

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