



By Mike Sudsina

Financial Market Regulatory Changes: Likely to Impact the Way Ohio Schools Issue Debt

As most of us know, in the wake of the financial meltdown of 2008, Congress has undertaken an effort to reform the financial markets through regulatory changes intended to guard against a variety of abuses that allegedly contributed to the hard financial times we are currently living through.

There have been plenty of headlines about how Wall Street and the housing mortgage market is subject to much of this reform, but Congress's tool, the Dodd-Frank Wall Street Reform and Consumer Protection Act, (Dodd-Frank Act) also contains provision affecting the municipal debt market including:

- Changes to the composition and authority of the Municipal Securities Rulemaking Board (the MSRB) and,
- Requirements for registration and regulation of previously unregulated swap and other municipal advisors.

The MSRB, which is the industry's self-regulatory agency, has had its Board of Directors reorganized to be comprised of a majority of public members, as opposed to its prior majority of private sector industry participants. The old board had 15 members, primarily comprised of bank and brokerage firm representatives with a minority presence of public sector members. The new board has 21 members with a majority of public members (11) with the private sector represented by four banks, three brokerage firms and the newly added presence of three independent financial advisors. The composition of the current Board can be found at the MSRB website www.msrb.org.

In 2010, the MSRB also established its Electronic Municipal Market Access (EMMA) system (www.emma.msrb.org). EMMA provides free access to current disclosure documents and trading activity of municipal bonds and has been designed

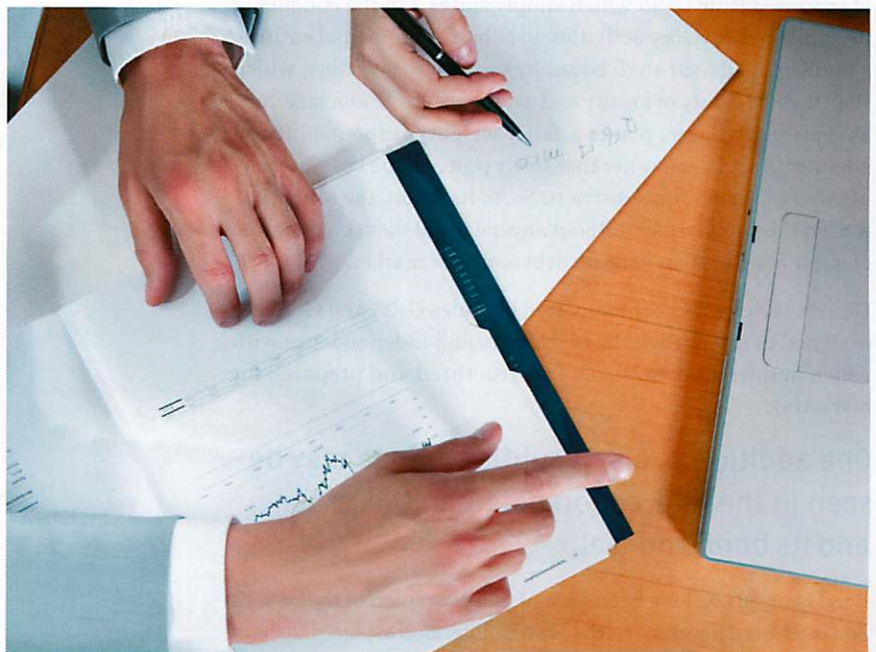
to assist with broadening disclosure requirements, including the online submission of continuing disclosure information under SEC Rule 15c2-12.

During 2011, the new MSRB board was particularly busy dealing with requirements for registration and regulation of previously unregulated swap and other municipal advisors, including those of us known more commonly as financial advisors. Unfortunately, some of this change remains in limbo as the SEC is charged by the Dodd-Frank Act to define what a municipal advisor is and does, but has yet to do so. However, that decision is expected in a matter of months.

MSRB did develop a number of proposed regulations affecting underwriters and advisors who deal with school bond issues.

These proposals are intended to draw attention to the inherent conflict of interest between the broker/dealer/underwriter's activities that serve the interest of investors — for example, to obtain the highest interest rate on bonds, while also claiming to be serving the best interests of the issuer (school district) by attempting to lock in the lowest possible interest rates on new bond

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issues. An astute school treasurer might wonder how can both objectives be met by the same organization?

One change intended to address this conflict was to existing Rule G-17 which addresses the conduct of municipal securities and municipal advisory activities. Rule G-17 state "In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice." It seems like a pretty good concept. The primary change was to add "municipal advisor" to the rule, thereby, for the first time, formally recognizing independent advisors and placing them under the requirements of Rule G-17.

Another related change modified Rule G-23 which permitted brokers and dealers to begin their relationship with an issuer as an advisor (assisting the issuer with planning and structuring activities), then later, switching roles to act as underwriter of the same securities they just structured. Market players have long viewed this practice as lacking a critical element of independence from structuring and sales activities that could be designed solely to benefit investors — to the detriment of the issuer.

Rule G-23 now prohibits such role switching, however, an underwriter may provide certain advice to an issuer without violating the role-switching ban if it clearly identifies itself in writing as an underwriter "from the earliest stages of its relationship with the issuer," discloses that it is in an arms-length relationship with the issuer, and its interests differ from those of the issuer. Yet, one might be left to wonder... If the interests of the underwriter differ from those of the issuer, who is left to defend the interests of the issuer?

Fortunately, the MSRB has contemplated a response in the form of proposed Rule G-36 which simply states, "In the conduct of its municipal advisory activities on behalf of municipal entities, a municipal advisor shall be subject to a fiduciary duty, which shall include a duty of loyalty and a duty of care." Fiduciary duty, as represented here, places a fairly weighty responsibility on advisors to act in a manner that solely protects the best interests of issuers such as school districts. So, to its credit, the MSRB has not left the public sector without anyone to aid them on their side of negotiations as they prepare debt issues for market.

Clearly, the changes contemplated by Rules G-23 and G-36 are designed to strengthen the objectivity and independence with which municipal debt issues are structured and prepared for marketing.

One additional, albeit subtle, change may be seen in the interaction between the issuer and its bond counsel.

Bond counsel has long been viewed as a champion of the issuer's best interests. However, it is the MSRB's intention to place fiduciary

responsibility on the municipal advisor. Thus, when it comes to details concerning structuring and marketing, the trusted attorney may be more willing to focus solely on the legal issues involved and defer to the advisor to provide such advice that will benefit the issuer on structuring and market conditions.

Issuing debt is becoming more complicated in this new regulatory environment. Here in Ohio, at the beginning of 2012, we have been through most of the Ohio School Facilities Commission-assisted projects so the number of new money issues has decreased significantly.

At the same time, while we are enduring this recession economy, obtaining voter approval for new issues has become more difficult. As a result, the supply of new bond issues has significantly declined and market participants are scrambling to stay busy.

Thankfully for issuers, this lack of supply is keeping interest rates at record low levels, leading to a good number of refunding opportunities designed to reduce debt service and ultimately save taxpayers money. Yet, like many other things, there is more than one way to accomplish favorable results, and if you seek the best result, arming yourself with well-qualified underwriters, bond counsel and municipal advisors will likely yield the desired result. The last thing you want to be seen as is: (a) the treasurer who inherently knows her/his bond pricing was off the market but has no one available to confirm their suspicions; or (b) the one who finds out shortly after the fact that a better structure yielding far better results could have been utilized. ■

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