TESTIMONY
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on behalf of the
Government Finance Officers Association

Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
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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 appointed 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.