

Reproduced with permission from Securities Regulation & Law Report, 47 SRLR 812, 4/20/15. Copyright © 2015 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

MUNICIPAL SECURITIES

Opportunities and Risks in Municipal Underwritings and Derivatives



BY BEN NEADERLAND AND HARRIET HODER

In the current economic climate, opportunities are expanding significantly for municipal underwriters and derivatives specialists as states and municipalities across the country clamor to pay for infrastructure and services, fill expanding budget gaps, and shore up unfunded or underfunded pension obligations. In evaluating and pursuing these opportunities, however, banks need to proceed with caution. Regulators are ever more focused on the activities of financial institutions in the municipal market due to possible disparities in sophistication between underwriters and municipal decision-makers, the potential for municipal financial advisor conflicts of interest, and issues surrounding the adequacy of disclosure concerning the risk profile of different financial products in a period of elevated volatility in global financial markets. In particular, banks

Benjamin Neaderland is a partner in WilmerHale's Washington DC office and a member of the firm's Securities Department. He may be reached at (202) 663-6340 or benjamin.neaderland@wilmerhale.com.

Harriet Hoder is a senior associate in WilmerHale's Boston office and a member of the firm's Litigation/Controversy Department. She may be reached at (617) 526-6203 or harriet.hoder@wilmerhale.com.

should cautiously assess and carefully document the appropriateness and suitability of proposed financing solutions and the disclosure to counterparties of risks associated with those solutions.

The Securities and Exchange Commission (SEC), Municipal Securities Rulemaking Board (MSRB), and the Financial Industry Regulatory Authority (FINRA) are all paying greater attention to these issues in 2015. The importance of scrutinizing transactions in this area cannot be overstated – a finding by the SEC of inadequate or inaccurate risk disclosure or a conflict of interest can lead to significant liability.

Growing Demand for Novel Municipal Financial Products

Times are tough for state and municipal finances. In September, 2014, Moody's Investors Service reported that:

Between 2004 and 2012, unfunded liabilities for [US state and local government pensions] . . . tripled to just under \$2 trillion; on an as-reported basis, unfunded liabilities quadrupled to \$601 billion. In addition to assets falling further behind liabilities, the plans are also facing riskier asset allocations and the burden of an older US population, leading to more risk for the states and local governments that fund them.¹

As states and municipalities struggle to meet budgetary needs and honor pension obligations, infrastructure and service costs and other expenses, they are increasingly turning to novel bond and derivatives products to raise capital.² This affords opportunities for underwriters and derivatives specialists, but also highlights the

¹ Moody's Investors Service, *Announcement: Moody's: US Municipal Pension Risks Higher Than 10 Years Ago Despite Recent Strong Asset Returns* (Sept. 25, 2014),

https://www.moody.com/research/Moodys-US-municipal-pension-risks-higher-than-10-years-ago-PR_309330.

² SEC Commissioner Daniel M. Gallagher, *Speech, A Watched Pot Never Boils: the Need for SEC Supervision of Fixed Income Liquidity, Market Structure, and Pension Ac-*

need for banks to assess a state's appetite for and understanding of risk. The state's decision-making may be colored more by the direness of its present financial situation rather than a reasoned assessment of its long term risk profile.

For example, Kansas recently garnered nationwide attention for proposing the issuance of \$1.5 billion in pension bonds with the goal of investing the proceeds to boost returns.³ While some see the issuance as a savvy move, others view it as a high-risk strategy.⁴ Illinois and New Jersey, both of which are also facing severe pension funding issues, have recently reached settlements with the SEC over charges that they insufficiently disclosed the risks associated with their pension bonds to investors. Illinois allegedly failed to disclose to investors in its municipal bonds that its state pension obligations were significantly underfunded and in danger of default.⁵ New Jersey ran into similar trouble in connection with its sale of \$26 billion worth of municipal bonds.⁶

Recent Cases – Sophistication and Disclosure

A number of recent cases highlight the possible dangers facing municipal underwriters.

In 2011, the SEC charged a national brokerage firm and one of its former executives with fraud in connection with a series of 2006 transactions with Wisconsin school districts. The firm is alleged to have defrauded five school districts by selling them unsuitably risky and complex investments. The SEC claims that the firm knew that the products did not meet the school districts' pension funding needs or levels of sophistication, and that it misrepresented the risk of those investments and failed to disclose material facts.⁷ The school districts' pension funds were devastated when the securities markets plummeted in 2007 and 2008. In announcing the charges, Robert Khuzami, then Director of the SEC's Division of Enforcement stated, "Let this be a teaching moment for sellers of complex financial products. The sale of these products to school districts or similar investors must meet well-established standards of suitability and accurate disclosure."⁸ That enforcement action is ongoing, and the SEC has settled with another financial institution for \$30.4 million in connection with the same offering.⁹ Notably, the complaint against the brokerage firm in this case made much of

counting (March 10, 2015), <http://www.sec.gov/news/speech/031015-spch-cdmg.html>.

³ Mark Peters & Aaron Kuriloff, *Risky Pension-Bond Strategy Considered in Kansas*, THE WALL STREET JOURNAL (Feb. 5, 2015), <http://www.wsj.com/articles/risky-pension-bond-strategy-considered-in-kansas-1423167830>.

⁴ *Id.*

⁵ SEC, *Press Release: SEC Charges Illinois for Misleading Pension Disclosures* (March 11, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513202>.

⁶ SEC, *Press Release: SEC Charges State of New Jersey for Fraudulent Municipal Bond Offerings* (Aug. 18, 2010), <http://www.sec.gov/news/press/2010/2010-152.htm>.

⁷ SEC, *Press Release: SEC Charges Stifel, Nicolaus & Co. and Executive with Fraud in Sale of Investments to Wisconsin School Districts* (Aug. 10, 2011), <http://www.sec.gov/news/press/2011/2011-165.htm>.

⁸ *Id.*

⁹ SEC, *Press Release: SEC Charges RBC Capital Markets in Sale of Unsuitable CDO Investments to Wisconsin School Dis-*

tricts (Sept. 27, 2011), <http://www.sec.gov/news/press/2011/2011-191.htm>.

the fact that numerous other financial institutions considered but ultimately declined involvement in the transactions at issue because of concerns regarding suitability.¹⁰ Similarly, in 2012, a major investment bank agreed to pay the SEC \$6.5 million to settle charges that it improperly sold municipalities (and other customers) securities structured with high-risk mortgage-backed securities without providing sufficient information about the investments or the associated risks.¹¹

These cases highlight the need for underwriters and banks engaged in the municipal finance markets to properly disclose and clearly explain risks to issuers and municipal derivative clients, and to scrupulously document disclosure activities at the time the transaction is being discussed. Regulators also expect banks to consider whether a product may be too sophisticated or otherwise unsuitable for the counterparty involved in the transaction.¹² Complicated municipal financial situations may call for complex solutions, but municipal financial product providers should be wary of proposing overly complex products that exceed the municipal client's ability to appreciate actual market risks.

Increased Regulator Scrutiny – Municipal Advisor Considerations

In the last year, the SEC, FINRA, and the MSRB have focused on protecting state and local governments in municipal bond offerings through regulation of municipal advisors.¹³ In a speech in November 2014, Andrew Ceresney, Director of the SEC's Division of Enforce-

ments (Sept. 27, 2011), <http://www.sec.gov/news/press/2011/2011-191.htm>.

¹⁰ Complaint, *SEC v. Stifel, Nicolaus & Co., Inc. et al.*, No. 11-C-0755 (E.D. Wis.), at ¶¶ 128-131.

¹¹ SEC, *Press Release: SEC Charges Wells Fargo for Selling Complex Investments Without Disclosing Risks* (Aug. 14, 2012), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483776> (alleging that Wells Fargo did not review the private placement memoranda for the complex asset-backed commercial paper investments or the extensive risk disclosures in those documents, relying instead on credit ratings, and as a result, Wells Fargo failed to appreciate and disclose "the nature and volatility of the underlying assets." Wells Fargo entered into the settlement neither admitting nor denying these allegations).

¹² The importance of suitability is also evident in the Dodd-Frank Act suitability requirements for swap dealers and security-based swap dealers that act as counterparties to special entities, such as municipalities. See 7 U.S.C. § 6s. In 2012, the U.S. Commodity Futures Trading Commission enacted corresponding regulations. 17 C.F.R. § 23.440. Under the regulation, a swap dealer recommending a swap to a special entity is considered an advisor and has "a duty to make a reasonable determination that any swap or trading strategy involving a swap recommended by the swap dealer is in the best interests of the Special Entity." *Id.* § 23.440(a), (c)(1).

¹³ States have also launched inquiries in recent years into practices surrounding municipal bond issuance. For instance, a special investigative report by the Pennsylvania Department of the Auditor General recommended that the use by municipalities of certain highly risky derivative securities be prohibited by law due to the relative inexperience of municipal authorities making purchasing decisions. See Jack Wagner, Pennsylvania Department of the Auditor General, *A Special Investigation of the Bethlehem Area School District, Lehigh/Northampton Counties*, at 3 (Nov. 2009). The report also identified deceptive marketing tactics employed by investment

ment, declared that it “is obviously a critical area for us”¹⁴ and that the SEC is “upping [its] scrutiny in this area.”¹⁵ Likewise, in 2015, FINRA “will focus on current SEC and MSRB municipal advisor requirements, reviewing for proper application of exclusions and exemptions, and potential unregistered activity.”¹⁶

These pronouncements are not just rhetoric.

- In a 2012 report on the municipal securities market, the SEC called for Congress to give it more authority over that market.¹⁷
- In January 2014, the SEC issued interpretive guidance for implementing a Municipal Advisor Rule, mandated by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, that requires municipal advisers to register with the SEC.¹⁸
- In August 2014, the SEC announced an examination initiative for municipal advisors through which it will scrutinize municipal advisors’ compliance with fiduciary duties.¹⁹
- Finally, in November 2014, the SEC, FINRA, and the MSRB held a compliance training event for municipal advisors. Of the training, Lynnette Kelly, executive director of the MSRB, said, “The outreach program will help reinforce the importance of complying with rules being developed for the municipal advisor community.”²⁰

This heightened regulation of municipal advisors also highlights the need for municipal underwriters and finance specialists to be vigilant of ethical concerns. On its website, the MSRB warns municipalities that they “should expect a high level of professional conduct from both underwriters and municipal advisors” and emphasizes that underwriters and advisors are required

banks and others involved in selling the complex securities. *Id.* at 7.

¹⁴ Leslie Norwood, *With Renewed Focus, The Spotlight Shines On Municipal Bonds*, SIFMA (Nov. 26, 2014), <http://www.sifma.org/blog/spotlight-on-municipal-bonds/>.

¹⁵ Kyle Glazier, *SEC’s Top Cop: More Muni Enforcement, Not Less*, THE BOND BUYER (Nov. 10, 2014), <http://www.bondbuyer.com/news/washington-enforcement/secs-top-cop-more-muni-enforcement-not-less-1067831-1.html>.

¹⁶ FINRA, *2015 Regulatory and Examination Priorities Letter* (Jan. 6, 2015), <https://www.finra.org/web/groups/industry/@ip/@reg/@reg/documents/industry/p602239.pdf>.

¹⁷ SEC, *Report on the Municipal Securities Market* (July 31, 2012), <http://www.sec.gov/news/studies/2012/munireport073112.pdf>; see also Gretchen Morgenson, *Policy Protection, Please, for Municipal Bonds*, N.Y. Times (Aug. 4, 2012), <http://www.nytimes.com/2012/08/05/business/muni-issuers-could-use-more-sec-protection-fair-game.html?pagewanted=all&r=0>.

¹⁸ SEC, *Press Release: Interpretive Guidance on Municipal Advisor Registration Rules* (Jan. 10, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540602870>; see also SEC, *Press Release: SEC Announces New Date for Compliance with Final Municipal Advisor Registration Rules* (Jan. 13, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540618042>.

¹⁹ SEC, *Press Release: SEC Announces Municipal Advisor Exam Initiative* (Aug. 19, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542678782>.

²⁰ SEC, *Press Release: SEC, FINRA and the MSRB to Hold Compliance Outreach Program for Municipal Advisors* (Oct. 1, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543084546>.

to “provide accurate information when giving advice or information related to the sale of bonds.”²¹ The MSRB’s rules provide specific guidance on the underwriter’s role in a municipal securitization.²² MSRB Rule G-23(d)(i) prohibits a broker-dealer from serving as both a municipal advisor and an underwriter on the same transaction.²³ The new SEC Municipal Advisor Rule also includes an underwriter exclusion that specifies how an underwriter may interact with an issuer without becoming an advisor.²⁴

Pursuant to the MSRB rule, appointing a municipal advisor is not and should not be the underwriter’s role. Nevertheless, it is in the underwriter’s interest, both reputational and in terms of mitigating future regulatory risk, to actively encourage potential municipal counterparties to take care in selecting qualified advisors who possess the requisite level of sophistication and experience to accurately evaluate transactions under consideration. There is a tension: While the underwriter must remain at arms-length from its municipal customer, and not exercise inappropriate influence on the municipality’s selection of its advisor, at the same time, the failure of a municipal customer to retain a sufficiently sophisticated advisor may create future peril for the underwriter. Regulators will take a dim view of bankers who evince awareness of a municipal advisor’s inadequacy or lack of experience, and nevertheless move forward with a municipal underwriting or derivative transaction.

Conclusion

Municipal finance bankers stand to benefit from the growing demand and opportunities currently developing in the municipal bond and derivatives markets. In pursuing these opportunities, however, banks should tread carefully and be vigilant of the unique risks that arise when dealing with a municipal counterparty. Banks should pay attention to issues of suitability of the products being offered, the quality of municipal advisors representing their municipal counterparties, and the clarity with which risks are disclosed. It may seem that certain of these responsibilities should not fall to underwriters and derivative providers; however recent history would suggest that banks would be wise to assume a heightened level of care given the expectations regulators have expressed for parties in municipal transactions. The regulators’ skepticism of those situations where the professionals all seem to generate significant fees in a financing transaction but the municipal client’s economic interest—and the public interest—appear, even in hindsight, to have been less of a priority, will lead to more aggressive enforcement actions in this area.

²¹ MSRB, *Six Things to Know When Issuing Municipal Bonds* (Jan. 2014), <http://msrb.org/msrb1/pdfs/MSRBSixThingstoKnow.pdf>.

²² MSRB, *Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities* (Aug. 2, 2012), <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx?tab=2>.

²³ MSRB, *Rule G-23, Activities of Financial Advisors*, <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-23.aspx>.

²⁴ SEC, *Registration of Municipal Advisors Frequently Asked Questions* (May 19, 2014), <http://www.sec.gov/info/municipal/mun-advisors-faqs.shtml>.