Session Four: The Fiduciary Obligations of Financial Advisors

Lynnette Kelly, Executive Director, Municipal Securities Rulemaking Board
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>> Okay, we are going to come back to our discussion. So we're going to transition now from the underwriters to financial advisors. We are fortunate to have Lynnette Kelly, executive director from the MSRB here with us. And David Leifer, the senior managing director from KNN to cover this topic. Do you want your bios read? No. I appreciate it, the humility. Again, we are going to focus on the financial advisor here and we expect to cover some other consultant services in the next section, so stay with us and we will wrap it all up with some meaningful conclusion. Thank you. Lynnette and David?

Lynnette Kelly, Executive Director, MSRB
Introduction Slide
>> Great. Thanks very much for having us. No one likes to hear a regulator or see a regulator except when a new rule comes out, so I feel very popular right now. So thank you for that. As is often the case when we provide materials weeks and weeks in advance of the session, a rule comes out in the interim. So I am going to skip ahead to, whoops, where am I going?

Slide 1: MSRB Mission (Kelly)

There we go. Here. I think you have everything on a thumb drive. But let me start by saying that the MSRB board is meeting at the end of October. And at that point we will have, devote a substantial part of their meeting to discuss municipal advisors, the regulatory construct for municipal advisors, the timing, the pace, the priority of any rulemaking initiatives. But, we do at least right now message that this is a very thoughtful process. It is a very methodical process. It is a process that is not just creating new rules for municipal advisors. Equally important is the outreach. Continued outreach to the municipal advisory community. It is making sure that municipal advisors understand the potential and the power of the EMMA system and help utilize the EMMA system to do their jobs more effectively and it also does include the rules regarding standards of conduct as well as the establishment of a professional qualification exam. So again, it is a very powerful, slow, methodical process. It relies a lot on engagement. It relies a lot on the regulator understanding the business. But also, a two-way street in terms of the advisory community participating in the rulemaking process. So I will talk a little bit about that later.

Slide 5: Defining Municipal Advisors (Kelly)

So Dodd Frank did have a pretty good definition of who they thought would be a municipal advisor subject for the first time it ever to a regulatory regime. The SEC approved the final registration rule just last week. And many of us are rereading or reading the 750+ page registration rule over and over and over again. You are going to get lots of great law firm memos. You're going to get a lot of insight over the next many weeks and months about what the definition means and where some of the trouble spots are. I have every expectation that the SEC really did try to get it right. But with anything this complicated there are sure to be issues coming up. But again, I think that certainly the SEC really tried to take into account all of the comments they got the first time around. I think they really tried to have a good understanding of the market and how this regulatory regime would impact the market. As important as the 775 pages is is what the SEC commissioners talked about as their public hearing when they actually approved the registration rule. So I'm just going to give you a really high level synopsis of what the five SEC commissioners talked about because it really does give you some indication of how they are going to approach their oversight and their approval process for MSRB rules.

Chairman Mary Jo White talked a lot about the need to protect municipal entities and investors. From abuses of a class of largely previously unregulated financial professionals. Commissioner Aguilar went even further and referred back to the financial crisis there revealed numerous examples of municipal advisors engaged in egregious conduct including pay to play practices, undisclosed conflicts of interest, the rendering of advice without adequate training or qualifications and the failure to put the interests of their clients above their own. Commissioner Gallagher spoke a lot about wanting to work with the MSRB on our related rulemaking and especially on seeing our economic analysis connected with those proposed rules. Commissioner Carol Stein talked about that she thought the registration rule was appropriately tailored in that it was focusing on the activity of the person and not necessarily the status or their particular function at the table. She thought the rules were clear, administrable and tailored in a way that is consistent with the statute in that it protected municipal issuers. And then Commissioner Pecora probably the most aggressively cautioned the MSRB and said how carefully he would be looking at any proposed rules to make sure that a very formal and thoughtful cost-benefit analysis was in place. If you remember, Dodd Frank has a very specific warning and charge that MSRB rules need to carefully consider the impact on small municipal advisors.

Slide 6: Current Municipal Advisor Duties (Kelly)

So fast forward three years. We have been spending a lot of time over the past three years engaging with the community, better understanding their business and trying to figure out really what made the most sense. We've had non-dealer municipal advisors on the MSRB board since 2010. We've had a dealer advisor on the MSRB board so there is a lot of talent and a lot of experience on the board itself. It is important to note that since 2010 there have been rules that do apply to municipal advisors. And those include the requirement to register with the SEC and the MSRB. The requirement to deal fairly with all persons and then Dodd Frank specifically says that there is a federal fiduciary duty for municipal advisors. So, those have been in place since 2010. The regulation I'm sorry, sorry. There we go.

Slide 7: Municipal Advisor Registration (Kelly)

So, the registration rule is much easier now. It's much clearer now that the SEC registration rule has come out. Now that there hopefully is more clarity around who is and who is not required to register, that will obviously make it easier for people to know whether they are in the ambit of the rule or not and start the registration process with the SEC and MSRB if they have not already done so.

Slide 8: Fair Dealing (Kelly)

As our chairman Jay Goldstone said this morning, fair dealing also applies to municipal advisors and it is as simple as saying you have to deal fairly with all persons and you must not engage in any deceptive, dishonest or unfair practice. And of course it is up to the MSRB to explain further how that applies in certain fact situations or with certain types of clients. And then the federal fiduciary duty, it does require a municipal advisor to put your client's interests ahead of your own. And again it's up to the MSRB to discuss and give further clarity to what a federal fiduciary duty means. And so we've had three years of hard work trying to establish and to articulate what is a federal fiduciary duty.

Slide 9: Fiduciary Duty (Kelly)

So the way that we approached this is that there is an abundance of state law fiduciary duty cases. There's common law fiduciary duty. There's certainly been an evolution of what fiduciary duty means. So that there's been a lot of legal analysis and research into the law, the case law of fiduciary duty. I think it's important to say, to make the point that Dodd Frank did establish a federal fiduciary duty, but that doesn't mean that the municipal advisors have been running amok and have had unfettered opportunity for misdeeds and wrongdoing. Clearly there is a state law regime for fiduciary duty. There's never any suggestion on the part of the MSRB that this is not a highly professional group of market intermediaries. I don't, wouldn't even think that the SEC thinks that, but there is certainly a regime state-by-state on what fiduciary duty means. What Dodd Frank did is just made it a federal standard so there's consistency amongst the 50 states.

Slide 10: Application of Fiduciary Duty of Municipal Advisors to Issuers (Kelly)

So I guess the question then is what does the MSRB think a federal fiduciary duty is found what that rule will eventually contain. What are the elements of the rule. So this is the first rule for municipal advisors that the MSRB board is going to tackle. They're going to take the first look at this in light of the registration rule at their meeting in October. And I think it's safe to assume that there is a duty of loyalty and a duty of care to the municipal entity. The recommendations of a municipal advisor must be in the best interest of your client. You have to achieve the necessary minimum professional qualifications in order to render informed advice. And you have an obligation to investigate reasonably feasible alternatives.

Slide 11: Application of Fiduciary Duty of Municipal Advisors to Issuers (Cont.)

You must disclose conflicts of interest. And you have to receive the consent informed consent of your client. And that there will also be certain conflicts that would be considered to be unmanageable. Meaning that, they would be prohibited even if your client agrees. And, that would be things like kickbacks, fee splitting arrangements, excessive compensation.

So, and again, I will get to it in a minute, but you will likely have to document your relationship with your client. We are well aware that sometimes municipal advisors are only engaged to do a very narrow part of the deal, or a very narrow piece of a review. And so it is important that you document the extent of that relationship and your compensation arrangements for that work.

Slide 13: Proposed Areas of Municipal Advisor (Kelly)

Disclosing conflicts of interest and the way that you do that, we've heard a lot about how that is done on the underwriter side. Hopefully we get it right, or at least the implementation of it a little bit better when municipal advisors have to disclose their conflicts of interest. The recommendations that you make to your client have to be suitable. You have an obligation to review the recommendations of other parties in the transactions. And again, there might be conflicts that are just simply unmanageable.

Slide 15: Professional Qualification Standards (Kelly)

On the professional qualifications side, I'm never sure I'm on the right slide, we have been working for three years now with a group of municipal advisors who have volunteered to be on a professional qualification advisory group. And that group meets every other month to develop a question bank for an eventual municipal advisory professional qualification exam. There are still many many open questions. Including grandfathering, including whether or not there should be separate modules for different kinds of municipal advisory services, the number of questions, the pass rate. So we have these industry professionals, this is the way that all securities-based exams in the securities industry, this is the way that all exams are constructed. It's like your child's SAT test. It is pretty important. Your livelihood depends on it. So the amount of rigor and analyses and the use of psychometricians and very sophisticated analytics into each and every question that is the question bank for such an exam is thoroughly vetted and tested so absolutely will be delivering a professional qualification exam but it is likely that it will be quite a ways away because we have to make sure that the questions are appropriately tailored in light of the definition of the municipal advisor.

Slide 16: Planning MSRB Resources for Municipal Advisors (Kelly)

As I mentioned earlier it is up to the board to decide the pace and the timing and the priority of the rule proposals. These are some of the proposals that were promulgated in 2012, but subsequently withdrawn. So the board may or may not choose to pursue rulemaking in some of these same categories. And this is really important because as a self-regulatory organization, the MSRB definitely knows that the best outcome for any rule is through an extensive public comment process. So you see there are two opportunities, at least two sometimes many more opportunities for public comment. This is something that the dealer community is well aware of and they know how to participate and engage on rulemaking proposals. This is absolutely something that we will need to work with a municipal advisory community on so that we get make sure we get the full extent of your comments and input. So you'll see a lot of work from the MSRB making sure that you know that there are rule proposals out there, teaching you how to file a comment letter, working with you to make sure you understand the intent of the proposed rule. And so it is something. And so we very much think that we will be viewed not only on the quality of the rules, but on the approach and the totality of the approach that we are taking for instituting a regulatory regime for municipal advisors.

Slide 17: Municipal Advisors: Preparation for Regulation (Kelly)

I'm going to close with, I wish we had done, we had to wait till the advisor but we plan to put out in the next couple of weeks some really good core, very basic but I think very important educational materials for municipal advisors. We are going to talk about the importance of registration. The importance of complying with rules. What does it mean to be regulated? Official communication channels. Make no mistake, but they are going to be compliance exams and reporting of unregistered municipal advisors. It is not the regulator who necessarily ferrets out unregulated municipal advisors who need to be regulated. It is the competitors in the room. So, there is certainly a process for that. We want you to learn about the MSRB and what it means to be in a self-regulatory organizational structure. We want you to understand the principles that underlie any kind of MA rulemaking, so the importance of supervision. The importance of disclosing conflicts of interest. Gifts and gratuities. Political contributions. Recordkeeping. We want to teach you how to participate in the rulemaking process, how the professional qualification exam is constructed. The importance of having policies and procedures. What an inspection looks like. And what kinds of questions might be asked. Suggesting that you review existing business practices, access available resources and most importantly stay informed. So, again, we want to have a very holistic approach to this regulatory regime. I know that there will be lots of questions, but let me turn it over to

The Fiduciary Obligations of Financial Advisors
David Leifer, Managing Director, KNN Public Finance

Opening Slide (Leifer)
>> Great, thank you, Lynnette and good afternoon, everybody. When Lynnette and I and Mark were talking before and planning for this session we agreed we'd each spend a few minutes presenting some ideas on how to frame this discussion. I think we will spend a few minutes after that asking each other a few questions that may illuminate these issues further and certainly want to open it up for further discussion.

Slide 1: Fiduciary Obligations of Financial Advisors (Leifer)

Let's see, here we go. First I just want to say what an honor it is to be up here with Lynnette, and what great timing. I don't know Mark if you can plan that, but having her here what a wonderful resource right after the MA definition was released by the SEC. So we are really fortunate and I want to acknowledge the work you've done and your staff and the board has done over the last couple years in holding these town hall style sessions to get input from the issuer community and the industry. I think it's been very helpful even when you were not able to answer questions yet, like when is the FA definition coming out. And I also wanted to acknowledge there are several advisors in the room today I see and I'm sure others that I don't see. So I invite you all to be part of the conversation. We are not a monolithic industry although some would paint us that way. There are small and large, there's independent, not independent, there are firms that just do FA and firms that have other ancillary services like swap and investment management and each of these is a different lens through which one might interpret the impact of the fiduciary duty. So I will do my best to kind of present the FA perspective but it is certainly more nuanced than any one firm can provide.

And finally my goal today is really to provide a practitioner's perspective on this and just by way of background I started my career in public finance, not a bond attorney but a transactional attorney for five years here in LA at O'Melveny and Myers. I did some bond work and then since 1993, so for the past 20 years I've been a financial advisor. So I have not worked in the broker-dealer side or in other roles.

So I want to store the whole concept of the fiduciary obligation and Dodd Frank. I think it's pretty obvious that this was not a real game changer for the well-established FAs. I think that most of us assumed that putting our client's interest ahead of our own was the norm. And I know for me personally and my colleagues, we haven't really changed our outlook and how we do our job. We are still doing what we did before because we always thought that was our mission and I think this formalizes it. But for most of us it hasn't been a big game changer. I think the new rules that are coming will be a game changer in terms of sort of the mechanics of the compliance regime. But substantively, it hasn't.

Secondly what Dodd Frank did was it formalized this distinction in at least the duty if not the role between the advisor and the broker-dealer and I think this is critically important, especially for the issuers in the room. I mean really critically important. We all know for example that an advisor or an investment banker can help give advice on structuring a deal or recommending a financing or preparing a rating presentation. We are both confident and capable in doing that but what this is telling us is that only the advisor when doing that is putting your interest ahead of their own by virtue of law. And that's a significant significant difference and that's why we see now in every broker-dealer PowerPoint we are not your advisor, we are not a fiduciary. Keep that in mind. Go get a fiduciary. I think it's interesting I'm sure the broker-dealers were supportive of this distinction and in some respects because it lowers the standard of care in what they do. But it's also helped the advisors and I think the issuer community in clearly defining it's almost as if Congress is saying and I know I'm biased here but Congress is saying to issuers, get a financial advisor because they are the party between these two that has to put your interest ahead of their own and I just can't underscore that enough. And I appreciate Natalie's comments today. I don't know if she's in the room now, about the role of the financial advisor, and I will take exception with Chris said a little bit earlier because I don't think that the sole reason to have a financial advisor is CYA. I mean certainly perhaps that contributes to it. But it is a much more robust role. It's much more nuanced than that and it's much more meaningful. He also failed to identify I think what he was talking about competitive sale in saying there is no expertise, there is no service. Of course there is none of that provided by the investment banker but certainly by the advisor there would be.

And then finally what Dodd Frank it is really put squarely in focus this question of conflicts of interest and that is really what I do want to talk about today from a practitioner's point of view. Not too much on the SEC action. Lynnette has covered that. I do think what's interesting is this idea is that the exemptions from the MA registration are based on activities, not based on the type of firm. So for example a bond counsel could be an advisor, or treated as an advisor if they're providing financial advice rather than legal advice. I'd be interested to hear from the lawyers whether there's gonna be extra training in-house but how many of us have been on calls where the bond counsels are offering thoughts on competitive versus negotiated or the marketability of different provisions. I certainly welcome those comments, believe me, more minds are better than fewer, but it does raise some new and interesting questions I think about whether they are now moving into the area of financial advice. And it's not just the lawyers, there's a number of participants we could talk about.

Slide 3: 2011 Draft MSRB Rule G-36 and Draft Interpretative Notice (Leifer)

But what is key is what's going to follow from Lynnette and the board in terms of rulemaking. And I think we use as a reference point the 2011 draft rule, particularly G-36, which addressed conflict of interest and the interpretive notice and other rules. This is obviously a starting point for us to think about it. Certainly the board is going to revisit all of this on first impression and it may not look nothing like this but I think it is obvious that this is a reference point. And Lynnette sort of walked all this already, so the duty of loyalty what I think is interesting about this is that it emphasizes a regime of written disclosure. So it's acknowledging that there are conflicts and it's saying what we are going to do is have the advisors disclose in writing these conflicts and we will have the issuer community acknowledge those. Written consent, or informed consent, sorry. So they are going to acknowledge they read the conflicts. We are going to disclose them to you and then we are going to proceed.

And it introduces this idea of quote unquote unmanageable conflicts, which I think is very interesting. Those are, they rise to such a level as disclosure and informed consent are not adequate. You simply can't do them. To me that is like the FA being one firm being FA and underwriter. G-23 sort of takes care of that perhaps but that would be an unmanageable conflict. And there are others that Lynnette mentioned and that is a new concept to me at least. It's an interesting concept that I want to explore further.

Slide 4: Potential Conflicts of Interest (Leifer)

So I want to think about conflicts of interest through this lens of disclosure, this regime of disclosure and share with you some of the conflicts that we see as practitioners and whether disclosure would be adequate, or are there other ways to protect issuers other than disclosure, or other than through the regulatory regime.

So, potential conflicts of interest. My starting point is clear. I think we can agree with the premise that no relationship involving compensation is free of a potential conflict of interest. So we just put that out there. There's compensation involved, there's likely to be a potential conflict of interest for any service provider that gives advice whether it's your home contractor or your plumber or financial advisor or bond counsel or underwriter, we are all getting paid to give you advice and we have an interest. We have a financial interest at a minimum. So I hear discussion about different forms of compensation. We can solve this with not contingent compensation or hourly compensation but also forms of compensation introduce their own potential conflicts and I list a couple of them here. But if you look at the non-contingent hourly model then you have the potential conflict of over servicing or padding your hours, perhaps. I'm not saying that that is what professionals do in reality but it is that potential that we are addressing. If you then say what about the contingent fixed fee model, which is often used then you have the potential for under servicing. We've quoted a fixed fee, let's spend fewer hours at it and we're going to get paid more per hour that way, potentially.

Then finally there's the obvious potential for self-serving advice. Where compensation is fully contingent on the completion of a successful completion of a financing, or worse, based on par amount. Here in California the advisors don't work based on par amount. I think there's a government code that prohibits that but in other states financial advisors do and they'll charge on a per bond basis and it's the same conflict that the underwriter faces. They make more money when you do bigger deals. That doesn't mean that they're giving you bad advice, but you need to be mindful of that when they are giving you advice.

So there really is no form of compensation that is entirely free of conflicts. And what the draft rule 36, G-36 did in the interpretive notice is they created a form. I think it was called disclosure of conflicts of interest with various forms of compensation-- A catchy phrase, but one that is probably going to be in some form used again. And it's a way by which the advisor can satisfy their disclosure obligation and providing great disclosure to the client and the client would acknowledge it. I think a regime of disclosure around the compensation is helpful so I'm conceptually supportive of it and I'm also concerned as well about calling out the potential conflicts only for advisors. And I know we are not doing that. I know the underwriters need to disclose in G-17 about compensation based on par amount and I think we need to be mindful of the other players as well--And the other professionals. So I just don't want us to make the FAs look scarier than the other professionals, especially when we have the fiduciary duty and in this case the broker-dealers have a slightly lower standard of care.

Slide 5: Other Potential Conflicts of Interest (Leifer)

So, other conflicts of interest that have been mentioned, excessive compensation. Certainly an important one. What is excessive? It's that old phrase you know it when you see it, I guess. And it's certainly something that we can talk further about whether that is an unmanageable conflict, or a disclosable conflict. But it's going to depend on the circumstances of the deal. I know when I propose a fee to my clients I prepare a memo, a long memo, and I explain the various elements of the deal that I think are the basis for the compensation, the various elements of the service, etc. And try and explain why the compensation is what it is but it's not an exact science by any means.

I put up here this sub bullet and I'm serious about it and I ask you to consider a focus on under compensation as well. It was said today I don't remember if it was by Chris or somebody else who said, oh yeah, you should use an FA because that is a cheap way of getting cover. It's not much money. Well that is true, it can be true. And yet I'm concerned that if our goal is to protect issuers, as I think it should be, in very complicated deals, then the FAs need to have resources and you need to incentivize your FAs to have the Bloomberg and the TM3. We spend almost $80,000 a year just on subscription services so that we can have good pricing information when we're holding underwriters accountable and pricing, so that we can train professionals, so that we can hire the most competent professionals, now you layer on an entire regulatory regime.

These are complex financings. Everybody this morning said there is no plain vanilla financing anymore and I don't disagree with that. Everything is complex now and you want your advisor to be equally capable as your broker-dealer in running independent deals and doing call option analysis, in running make whole call, break analysis that is something a client just asked us to do, complicated, requiring expertise and resources and so I am concerned about this spiral race down to the lowest compensation.

What I'm hopeful is that the enlightened issuers will, in their selection process focus on experience, capabilities protections and other things as much if not more than just compensation. You know, I've been on deals where management fees have been proposed in excess of $1 million and on those deals you know an FA is expected to hold them accountable through pricing with the fees under 30, $50,000 and we are going to find ourselves in a place where that becomes problematic I think.

The next area of conflict is dual roles or selling of multiple services within a transaction. This is an obvious one, I think. Certainly if you were an FA and an underwriter that would be a conflict and that's prohibited but what about some of these other services? If I'm the FA and also providing investment management services on the backend for your bond proceeds or for other elements, perhaps your treasury monies, there's a potential for conflict. I might underprice my bond services to get in and then charge other fees on my investment management. Same with swap advisory. Our firm made a conscious decision not to provide swap advisory services and I think if you look back at the preponderance of deals that were done with swaps, it's, you probably will find financial advisors on those deals that were also swap advisors. It might be that those issuers knew they wanted to do the swaps and went and got those advisors or it might've been the other way that the advisors were perhaps more open to the use of complicated products like swaps because they offered that extra service and stood to have financial gain. I think probably the best practice would be to use separate firms at a minimum for your financial advice and your specialty advice. And the really highest sort of practice for the advisor would be to probably not provide those ancillary services. And that is a conflict that certainly should be disclosed, I believe. An issuer should be aware of it.

GO bond election services are another example in the school finance community. Advisors also providing campaign related services. Again, are you picking your advisor because they're a good advisor or because they're offering perhaps a reduced rate or free campaign on your school bond election? Clearly as an industry I think we want to create the right incentives to pick the right players because of their expertise in what you're looking for and not because of some financial arrangement.

Moving on here, payments to or from third parties. Certainly if I'm your advisor on a deal and I'm receiving some sort of payment from another member of the team, the issuer needs to know that. I can't think of a situation where that's happened, at least not for our firm, but that's a disclosure item, disclosure regime I think can handle that. Certainly finder’s fees are another example. We don't do that, but, and I think that's going to be prohibited. But these are the types of potential conflicts that as practitioners we are, need to be aware of. We need to be fully disclosing to our issuer clients and the issuer should be looking at those with a keen eye and again, I really think paying attention to hiring the firm you want as a financial advisor because they're good at being a financial advisor, not because they also provide these ancillary services.

Non-client alliances. That is a tricky one. This is something that might fall in the area of secondary conflicts perhaps. It's not going to come as a big surprise to many of you that there are FAs and underwriters that seem to show up a lot on the same deals. Perhaps there are broker-dealers that know that the issuer will be using an FA and they might prefer to recommend an FA because maybe then they are a little easier during pricing or whatever it is and that FA that was recommended maybe they feel a little loyalty to the broker-dealer and maybe they will be a little easier during pricing which does not serve the issuer. That's a hard one. There's no written document. There's no written alliance. Nobody's going to actually disclose that, whether it's G-17 or some other form. So the issuer needs to be mindful of this and I'll talk a little bit about ways we can avoid that through our own reputational risk, basically. But the good FAs, I think, won't do that and unfortunately it falls on the issuers to figure out who those FAs are and where those alliances are.

I will tell you I know that G-17 now prohibits the broker-dealers from telling issuers you can't hire an FA, or you shouldn't hire an FA. But there have been many places I know of where bond counsels have said that perhaps that maybe you don't need an FA here, or you should use that FA and there are implicit alliances going on there as well and we just need to bring some sunshine to those.

Slide 6: Still Other Potential Conflicts of Interest (Leifer)

Okay, finally, still other potential conflicts of interest, refundings. A perfect example of the potential for self-serving advice. We run numbers, broker-dealers run numbers, we show savings and a deal gets done and the professionals will serve on those deals and stand to make additional compensation from those. Use of complex products or structures. Certainly the more complicated the deal, the more that higher compensation is justified. So there is again an inherent conflict or self-interest that the professionals might have when recommending those types of things. I think those are things that issuers need to be mindful of. One way to address those is through issuer policies and good debt management policies. Most issuers I think do have good debt management policies on refundings that you will have a minimum PV savings threshold you have a higher PV savings threshold for advanced refundings or refundings that might involve a derivative. And then with swaps there will be a policy certainly at a minimum that there be a separate policy on swaps that requires the issuing entity to really evaluate the risks and the use of debt advisory committees I think is very good. Get multiple people from the issuer together to sort of talk about things and not just rely on the advice of any one party, but to get the best minds from the issuer in the room at the same time. I think that's helpful.

Slide 7: Ways in Which Issuers are Protected (Leifer)

So ways in which the issuers are or can be protected. You know, right now I think reputational risk is something that the well-established FAs are mindful of. Really, our reputation is our calling card. It is our brand, word-of-mouth. If we disappoint our issuers by giving them bad advice we will not do well in this business. And I think that's an important consideration and it works. Regardless of regulation. There are other players on financing teams. The bond counsels, the underwriters are also certainly mindful and telling issuers certainly when they think the advice of the financial advisor might be misguided and that's appropriate. I don't have a problem with that. I think the more minds of the table, the better.

Let's see, emphasize competency and experience. This is for the issuers. I mean, what can you do to help mitigate these conflicts? Well, good good FAs, get good advisers who are competent, who are experienced, who have a philosophy of disclosure that is consistent with yours and a bias toward protecting our interests. Inquire about our internal policies and our practices. I'd be all for that. As our firm for example I instituted a rule at our firm that we can't accept gifts. It's actually not an MSRB requirement yet for us or any other regulatory requirement. We can't accept gifts from underwriters or from bond counsels. That even means lunch. So when I get a phone call from broker-dealers as I often do to go to lunch, we always pay our own way. It seems kind of silly $20 is not going to really change the world and the way I do business but I want to avoid even the potential for a conflict of interest. Our firm we have what's known as a firm element. It is on-going education; we bring people into the firm for training. There are, as I said, these internal policies about client entertainment. We track all sorts of information about that and we have very strict rules. We, for example will not work on bond campaigns. We won't do investment advisory work, don't do swap advisory work. That's an internal policy that might be relevant to you. Ask that question in your RFP please. I really think it's important if you care about getting the kind of independent advice that we are all trying to aim for. So I think there are ways that the issuers can take the bull by the horns as well and ensure that you're getting the kind of advice, don't just look for the low fee. Would be my advice.

And finally the regulatory framework and I think regulation is important. It provides consistency and continuity and makes sure that everybody plays by at least a minimal set of standards. I hope we aim for even higher than the regulation but we are all going to play by those rules. We have G-17 right now that does apply to FAs as well as broker-dealers in terms of a duty of fair dealing. We have the revised rule G-23 which as was discussed earlier says that we cannot switch roles if we are an FA and a broker-dealer on the same transaction any longer. And that is a significant change. We have the proposed rules G-66 that I talked about earlier. I think there should be other MA rules about political contributions and gifts and gratuities. And record-keeping and supervision and these things. And I think that that is going to be part of the regime that comes.

And I think that, finally implement meaningful competency and continuing disclosure requirements. I mean, this is critical. I mean, at the end of the day you want to have competent advisors and our best way of ensuring at least minimum levels of competency is through the exam, so I hope we will talk a little bit more about the examination process and how that is being prepared and the same really should apply to broker-dealers and their continuing ed. Because I work with an FA that is affiliated with a bank, we are subject to the MSRB rules and I have these continuing education tests that we take. I have a series 52 and the series 53 and often the continuing education exams have not absolutely not a single question on municipal finance. Not one question on municipal finance. Covered call options and you know, 529 plans and all the other products that we don't provide. So it applies equally to our broker-dealer community and those professionals as it does to FAs. We want to rise to the level of competency throughout the industry. I think that will be good for all of us.

Slide 8: Rulemaking Considerations (Leifer)

And then, let's see. Finally a few rule-making considerations. I'm very supportive of the regime for disclosure and client consent. But I think we should be aware of the pitfalls that were discussed earlier about G-17 and that disclosure. What we don't want to do is end up with a regime of very long, legalese oriented disclosures to our clients. I think the goal should be issuer education. We want to inform our clients about meaningful conflicts tailored to those circumstances on that deal. And hopefully we can together help craft requirements that will do that. I do hope that there are these other rules will come out and then I think finally just a word of caution to Lynnette and the board and others about regulation and that it should be appropriate in scope and burden to the role, to the types of firms, to the types of entities that serve as financial advisors. I think we've all acknowledged and you said this, Lynnette, as well that many MA firms are smaller and have far fewer resources than broker-dealers. So we have to balance the benefits of regulation with the burden and the cost and we really don't I think, even though I work for a bigger firm, want to drive out the smaller firms for the benefit of our industry. We want to avoid sort of overly burdensome regulation.

And then finally, my last admonition, and that is let's not assume that FAs or municipal advisors should be less trusted through this regulatory regime than our other players in the financing, other players or members of the financing team. I mean remember it is the advisor that has the fiduciary duty, not the lower standard of care. So I am just concerned that through the regulatory process that we do not lose sight of that, that the regulatory approach is appropriate for the duty as well as for the scope and burden of what advisors do and don't do.

So I think I'm going to end there and maybe we will do a few questions and answers between us and then we will go from there. Maybe I will just start, Lynnette, since I'm standing here. And can you address, maybe already have, but the rule, G-36, I mean is that a reasonable place if the FA were trying to determine what should they do now, what are they likely to be required to do, would the G 36 and the other rules that were promulgated previously be a starting point?

Lynnette Kelly

>> You know, I don't, I think it is fair to assume that if the board three years ago thought that those were the priorities that it's likely that they will be the priorities for this board. But I can't, I don't know that. That's certainly a board decision. The rules that were promulgated you know, we've gotten smarter over time. We've had more engagement with the community, we now have a registration rule. And so, all of the rules that have been proposed need to be looked at again in light of the registration rule. So I think that sure, go ahead. If you want to look at them. No, but I think what you can do right now is you prepare. And again, within a week or two you will have a really good guide for non-dealer advisors to really sign up for information, get on mailing lists, understand, participate in webinars, look at your policies and procedures. So there's a fair amount to do just to kind of get off the ground and then as we start to promulgate rules, there will be a significant education effort and a lot more engagement.

David Leifer

>> I'd follow-up with one other question and that is just on the examination front which I do think is important you mentioned you've had this working group has been meeting and it is a complex process and I acknowledge that. Two questions, one, are there practitioners as well as academicians involved in it because I think it would be useful because we have a sense of sort of the real world if you will, and then two, what about continuing education? Will there be requirements for that?

Lynnette Kelly

>> Right, so the folks that are involved with the professional qualifications advisory group are practitioners. They do represent traditional municipal advisory activities, swap dealers, investment proceeds. Investment of bond proceeds. So people from sort of different parts of the advisory world that will have to be expanded in light of the new registration rule. But, absolutely. You know, again, securities licensing exams do rely on the input of the practitioner. Continuing education, there are currently continuing education requirements for the broker-dealer community. It will be up to the board to determine what, if there will be continuing education requirements and if so, how many hours? What does that look like? But I think you should expect that that will come in concurrence with the exam. I have a point, though, to make.

David Leifer
>> Sure, please

Lynnette Kelly
>> Which is, we've had three years really to study this industry and remember that what might be the practice in California may be very different than Kansas or Nebraska where I'm from, or the South. And so, when you want to talk about conflicts of interest, make no mistake that there are significant conflicts of interest in the municipal advisory world that issuers will really need to be aware of. And it's very situational. It's very dependent on the region of the country, the type of advisor. My personal favorite is a firm that was an advisor who referred issuers to an accounting firm run by the brother of one of the partners. Referred to bond counsel who was the cousin of one of the councils, referred to a printing company owned by a cousin and then also engaged in headhunting activities where they placed municipal finance officers in their client's shop. So, let's hope that this is just an anomaly. But for the issuers in the room I think it really is important to understand that conflicts, you know, we don't really worry about the San Diegos of the world or the sophisticated issuers, but for the many many many issuers out there who place total reliance on their municipal advisor, these kinds of conflicts must be disclosed and mitigated and certainly there needs to be informed consent. So I'm not trying to throw the advisory community under the bus, but it really does depend on what region of the country you are in and what kind of activities they undertake.

David Leifer
>> And I think it's generally going to be in our interest, our being the FAs in this room to root out that kind of behavior. It just doesn't serve anybody's interest, really in our overall industry. So I want to kind of raise the integrity of the industry and I think we will all be well served, including investors.

Lynnette Kelly
>> We're going to put you down for the first professional qualification exam, so you will be the test case.

David Leifer
>> Did you have any other questions for me, or and then we can...

Lynnette Kelly
>> Let's open it up. Questions from the audience? Yes?

Question
>> I think I know David's answer for this do you feel is possible for [inaudible] no potential for conflicts of interest [inaudible].

Lynnette Kelly
>> Absolutely. I mean other than the compensation, which as David really very articulately stated, no matter what your compensation arrangement is, it presents conflicts. There are many scholars in the industry who think that contingent fees for municipal advisors are an unmanageable conflict. And should be prohibited. That would be a pretty significant deviation from industry practice. But, I think it is important for issuers to understand that if your compensation is dependent on the deal closing, that's a conflict that you should fully understand. And that is certainly no different than bond counsel or other parties to the transaction who have a similar motivation.

Question from Audience
>> I just have [inaudible] is this on? Okay, as long as you are speculating since that's all you really can do today, could you speculate about who you think will get caught up in the web of regulation? I mean, the FAs in this room all knew we were going to be regulated. This is not, the 750 pages are interesting to see who else might join our club and I'm just wondering where you think you're going to draw the lines and again I realize it's speculative.

Lynnette Kelly
>> Right. I think there is still speculation about the extent of the underwriter exemption. I think the SEC tried to avoid duplicate regulation, so banks doing traditional banking activities that were already subject to banking regulation would be exempt. So someone, the Bond Buyer, not me, but someone said it seems that every trade association got what they wanted. And so I think it's going to take some time to figure out, you know, where the pressure points are, or where the lack of clarity is. But I think it's a pretty narrow group. I think it's focused more on traditional municipal advisors. I think it avoids duplicative regulation. I think the difference is that the MSRB and municipal, the municipal advisory regime has the mandate to protect issuers, whereas

other regulatory schemes maybe worry about the safety and soundness of the banking system, or they worry about protecting investors. They don't really put the protection of the municipal issuer front and center. I think it will take some time to work out the kinks to see where the gaps are. I can put David Sanchez on the spot here. David was a colleague, but at the SEC during much of this time and, do you have any sense of, David has left the government service now, so...

David Sanchez (Audience Participation)
>> I think the two main areas that we heard about were engineers and actually attorneys. And so I think those would be the people that based on anecdotal evidence that we would be most likely to step over the line. Attorneys in a competitive sale. We heard a lot of evidence that they actively discourage the hiring of FAs. And step into the FA role and there are a lot of engineering firms and again this seems to be more of a Midwestern phenomenon that do a similar type of thing where they present a prepackaged deal. So it is not the engineering services but it's the complete financing to implement the engineering services. I think that is the two groups that are most likely to join the club.

Lynnette Kelly
>> I'd be interested to see whether the engineers or others that do feasibility studies are captured because many of us think that there's a real issue in the business. Where feasibility studies are relied upon and perhaps are not as, the analysis is not as robust as it could be or should be.

Unknown
>> I think there was another question here.

Lakshmi Kommi (Audience Comment)
>> David, you have some very good ideas for us as issuers as to what we can include in the RFPs going forward. Too bad one of the RFPs went out for us just last Monday.

David Leifer
>> Maybe we should add, give an addendum or else.

>> You can still ask the question in your interviews.

Lakshmi Kommi (Audience Comment)
>> Of course and on your comment advice to the issuers, don't look at just the bottom line compensation you know, the lowest fee. I think I'm speaking for my issuer colleagues here, I don't believe we go just for the lowest cost, especially in California. Although, there are a few, very few independent advisors, the reality is they are really a very good group. So within that group there is perhaps healthy competition. So we as issuers and [inaudible] our obligation also lies on getting the lowest cost and where you would provide the best service as well. So, it is a balancing act. So that everyone here is aware, we are not just going for the CYA, let's just get some FA, but also it's that compromise with the lowest cost as well.

David Leifer
>> I appreciate that so I'm going to take that when I lose on fee. I understand that. There is a community of very competent and qualified FA's, I do think that within them though, you will find that there may be firms that are more experienced in one type of financing than another, that might be better suited for whatever it is your need is, sometimes it will be us, sometimes it will be the competition. And I think, you know, I was involved in a deal many years ago an RFP with a county that will remain nameless, but they got a fee proposal from a pretty big-name firm for $17,000 I remember it I think, or 15, 17, for a complicated deal. And in their internal committee they told me later that they just threw it out because that couldn't possibly reflect the appropriate level of service that they would need or expect even though it was a competent firm. So you know, I do think that that kind of view of sort of a patently absurd proposal both at the low and high-end helps the industry generally to ensure that you continue to get good service from, you know, the bulk of your advisors. But I appreciate the comment.

Lynnette Kelly
>> I can tell you that another thing that certainly hit the radar screen is to what extent do issuers require advisers to have professional liability insurance. Because it's great to have a fiduciary duty, but what happens if there is a problem? Our board has certainly not you know, made any determination or decision about that but it's certainly I think a question, or certainly something to take back and question.

David Leifer
>> You know, I will comment on that. I think it's a fair point. This duty now exists. There

certainly is the potential for liability by the advisory firm and you know, I'd rather us think more about how we can make sure things are done right at the front end but knowing occasionally they are not, how does the issuer recover if there was a liability claim and professional liability insurance certainly is one way. Obviously a firm that is well-capitalized is another. I think my leaning would probably be more towards the issuers asking the questions. That's another good question for your RFP, than the mandate. Is my initial thinking, but I think if you go with the mandate approach I think again it is a balancing. You've got sort of the benefits of protection on the one side and the burden on the other. Hopefully the market would speak and the market would say we're not going to hire FAs without that, so most FAs will then migrate towards it. It can be costly especially for the small firms it can be hard to get so I think we've got to be mindful of that maybe there's things as an industry we can do to help educate the insurers they are not even familiar with the types of claims and I think we need to go back again also to the duty of care, that last bullet on the duty of care. It says the advisor is not a guarantor. And that is really important. We have a duty of inquiry. We are supposed to show you alternatives. Ultimately the client makes the decision. If it turns out to be a good or bad one for their needs we were not a guarantor. So if there is a requirement it should be appropriate to the type of liability that we might have. I can imagine it's costly just get one or $2 million of insurance for a small firm let alone 10 million or something that probably would be out of proportion to the nature of the claim against them. Mark, anything else?

Lynnette Kelly
>> Thank you.

David Leifer
>> Good, thank you.

Mark Campbell
>> Thank you, Lynnette, David. I think you covered everything from my perspective, good job. All right, we are going to move into the next and final panel. So, if I can have Robert David and Tim?