

BLOG POST

## Post-Election Update: Financial Services - Municipal Bond Market Regulation

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The regulatory "to do" list for the Securities and Exchange Commission (SEC) and Municipal Securities Rulemaking Board (MSRB) contains many items left undone from the Dodd-Frank Act. Most of the delay has been at the SEC. The prospect of reinvigorated leadership in the wake of the re-election of President Obama may enable the SEC to expedite long overdue rulemaking as well as pursue an agenda adopted this past summer for upgrading municipal market regulation. President Obama's re-election will influence the tone of future SEC activity and the resulting effect on the municipal bond market, but without the prospect for change as great as may affect a key feature of municipal bonds – tax exemption.

- The post-election regulatory environment for the municipal securities market is determined not only by the results of the Presidential election but the Senate and House results as well.
- With President Obama returning for a second term, the Democrats in firmer control of the Senate, and the Republicans retaining control of the House, some may see little prospect for change in the financial regulatory environment from the past few years of gridlock. A closer look indicates the possibility to move forward, at least at the regulatory level, and particularly with respect to the municipal bond market.
- President Obama will nominate the candidates to fill future openings among the five Commissioners of the SEC. Current Chair Mary Schapiro has made no public statement, but the "buzz" is she is ready to step aside. Whoever President Obama nominates to replace her will set the agenda for the Commission and for regulation of the municipal securities market along with the pace at which it is pursued.
- If as many expect, Chairman Schapiro steps aside, current Commissioner Elisse Walter is a likely candidate to move up to replace her, provided she secures Senate confirmation. Walter assumed a "hands-on" approach to municipal regulation early in the first Obama administration, taking the lead in the work leading up to the Commission's recent Report on the Municipal Securities Market. The Report established a road-map for future Commission regulatory action as well as legislation the Commission could pursue in Congress. The other Democrat Commissioner Luis Aguilar (Schapiro is an Independent) was reappointed in 2011 and is likewise a possible successor to Schapiro as Chair.
- Should either Commissioner Walter or Commissioner Aguilar advance to the Chairman's seat, the President may nominate a third Democrat to fill the seat (of the five Commissioners, no more than three may be from the same party). Of course the

President may look beyond Walter and Aguilar for his choice as Chairman.

- Among the two Republican Commissioners, Troy Paredes's term ends in 2013 and Daniel Gallagher is newly appointed in 2011. Both have voiced concern about potentially deficient Commission rulemaking practices, particularly with regard to cost-benefit issues, a concern not easily dismissed in light of a string of successful challenges to Commission rulemaking in the U.S. Court of Appeals for the District of Columbia. Both strongly dissented to the Commission's approval earlier this year of MSRB action requiring underwriters to prepare extensive written disclosure letters to issuers of municipal securities in advance of bond underwritings. This concern is unlikely to disappear from future Commission rulemaking action without the Commission demonstrating stronger response to the Commissioners' concerns.
- Whoever is nominated to succeed Chairman Schapiro will require Senate confirmation, starting with the Senate Banking Committee. The same holds for additional Commissioners. The Democrats have expanded their majority control of the Senate. On the Banking Committee, Senator Tim Johnson will likely return as Chairman. Republican Richard Shelby, current Ranking Member of the Banking Committee, will likely leave to become Ranking Member of the Appropriations Committee and Senator Michael Crapo of Idaho may succeed him as Ranking Member of the Banking Committee. With Senators Kohl and Akaka retiring, Democratic membership of the Banking Committee will change. One possible new member is Elizabeth Warren of Massachusetts, who defeated Republican Scott Brown. How she translates her pro-consumer, anti-Wall Street perception in her role as a first term Senator will likely affect the tone of the Banking Committee as well.
- Congressional action on regulation of the municipal bond market, if any, will likely center on modifications to Dodd-Frank (the Dold bill below) and actions of the legislative proposals to increase SEC authority over state and local governments issuing municipal bonds identified in the SEC's Report.
  - **Dodd-Frank.** While a Republican House and more Democratic Senate will likely retain their divided views of the efficacy of Dodd-Frank, the success in the House in late September of the Dold bill clarifying provisions on municipal advisor regulation – 60/0 vote out of Financial Services and passage by voice vote in the House – is a good indication that regulation of municipal advisors and other Dodd-Frank provisions regulating the municipal securities markets stand apart from other Dodd-Frank elements. The Dold Bill, which could be taken up in a lame duck session, is a clear cry of Congressional frustration with the pace of SEC rulemaking. How the SEC responds will likely be determined by the factors observed above.
  - **SEC Legislative Proposals for Increased Municipal Market Authority.** The Report identified several changes to existing securities law to expand SEC authority, among them removing exemption from registration for conduit borrowers, allowing the SEC to dictate "principles based" disclosure, and granting SEC authority over the form and content of state and local government financial statements, that the SEC could recommend to Congress. Whether or not it does so may depend upon the leadership of the SEC. A Chairman Walter would likely have these measures as a priority. Even if recommended to Congress, whether anyone emerges to champion

the SEC's cause remains to be seen. Tough tasks lie ahead in any event. For example, explanation of why U.S. state and local governments would have to adhere to SEC financial reporting standards in order to enter U.S. securities markets while foreign governments and their subordinate states and provinces currently do not, will have to be made. But again, the SEC has yet to make any recommendations.

- SEC Rulemaking in the municipal market has stalled, with the Dodd-Frank mandated rulemaking on regulation of municipal advisors kicked down the road for the second time this past September. SEC staff statements indicate the rulemaking may be ready to put before the Commission as early as January. How the current Commission or a Commission of four under an Acting Chairman Walter will respond may depend on how well the proposed final rule responds to concerns of the individual Commissioners, including those of Commissioners Gallagher and Paredes noted above. Similar considerations affect Commission action on final terms of the Volcker Rule and the definition of municipal securities within the Rule, which if not revised may affect liquidity for certain municipal bonds as well as issuer costs. When the SEC does complete its municipal advisor rulemaking, it will face a flood of MSRB rulemaking proposals on municipal advisor regulation waiting in the queue.
- Rulemaking by the MSRB will likely be extensive. The MSRB has a lengthy list of rulemakings pending to regulate municipal advisors. The MSRB first proposed many of these rules to the SEC, then withdrew them after the SEC delayed its basic decision of who is and who is not a municipal advisor. Once made by the SEC, the MSRB will re-introduce rule proposals governing the basics of regulation - qualification, testing, and periodic inspection, as well as conduct and client and market protection rules, including definition of the fiduciary duty owed by a municipal advisor to its clients, limits on gifts, and pay-to-play restrictions. All will have to pass through and be approved by the SEC.
- The rulemaking process employed by the SEC in considering its own rulemaking, as well as those proposed by the MSRB, is subject to the same legal requirements highlighted by Commissioners Gallagher and Parides in their dissent earlier this year, as mentioned above. The U.S. Court of Appeals for the District of Columbia has successively ruled against the SEC in process based challenges to SEC rules in recent years. Whether the SEC's rulemaking processes survive challenge in the future is yet another factor to be considered, should any of its municipal market rulemakings be so challenged.