

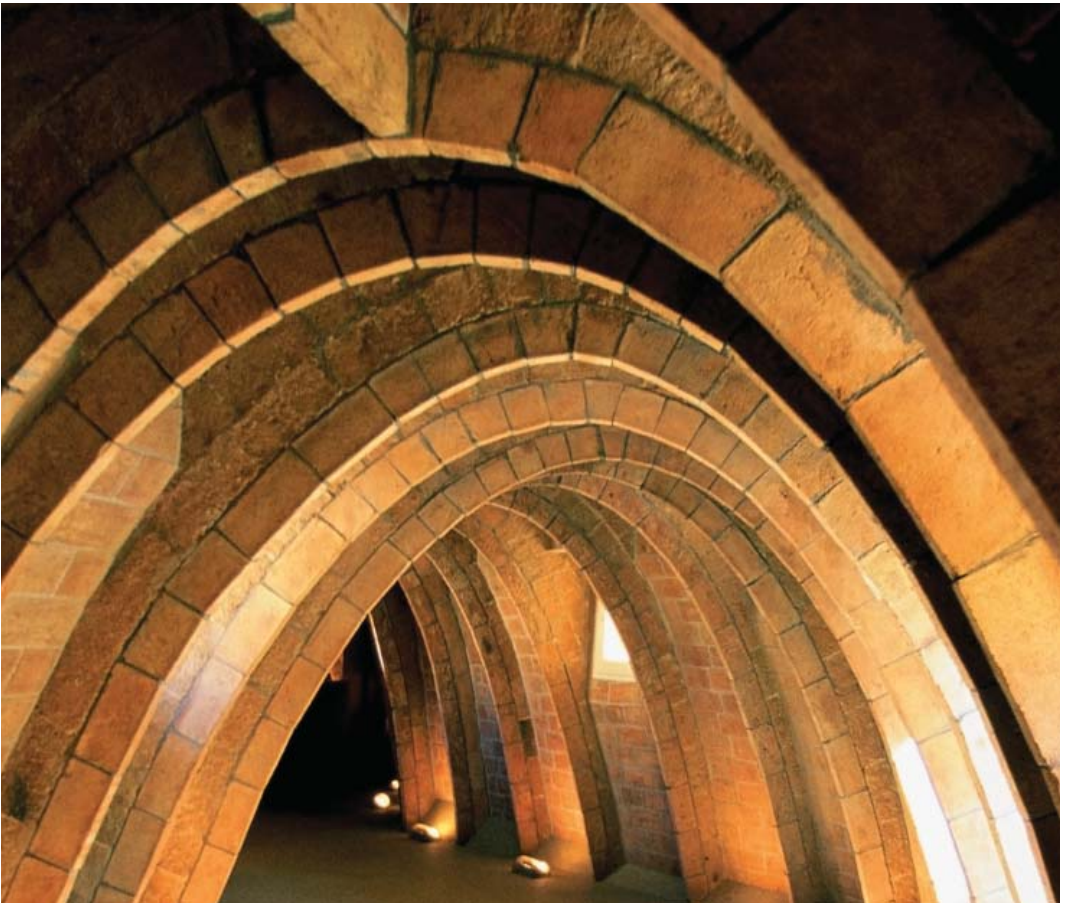
Innovation Series  
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# A Perfect Municipal Storm

Taken together, the issues facing the municipal bond industry may bring on further regulation



THE BANK OF NEW YORK MELLON.



The U.S. municipal bond market has evolved greatly over the past two centuries. It has withstood defaults, the Civil War, the Great Depression, and world wars to become the leading method for financing infrastructure and public services, such as schools and hospitals. By year-end 2006, total short- and long-term municipal securities issuance had reached \$431 billion, according to the February 2007 issue of *Research Quarterly*, a publication of the Securities Industry and Financial Markets Association.

This phenomenal growth serves as a testament to the effort issuers and underwriters have made in raising capital and to the ability of regulators and rating agencies in protecting muni bond investors. By almost any measure, the municipal bond market is healthy, strong, and growing. Behind the scenes, however, things are less sanguine:

- A patchwork of regulation continues to stymie oversight.
- Retail investors still do not enjoy the same transparency readily available in the corporate debt or securities markets.
- Unfunded Other Post-Employment Benefits (OPEBS) liabilities continue to be unknown and unaccounted for by debt issuers, rating agencies, and public accounting firms.
- A looming U.S. Supreme Court decision may forever alter the tax deductibility of municipal bonds.
- Ongoing collusion, bid-rigging, and price-fixing investigations by the SEC and Justice Department are creating a negative perception of the industry.

These issues, in and of themselves, are not necessarily causes for alarm and may not lead to additional regulation. However, taken together, they suggest a perfect storm may be brewing. We believe the municipal bond industry has a limited window in which to address some of these issues.



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## Federal Versus State Sovereignty

One issue, as old as the Republic, has overshadowed the municipal bond market since its inception: federal versus state sovereignty. The ability of the federal government to impose its will on the individual states has been disputed in wars, in the courts, and in Congress.

The sovereignty question led to the muni market's greatest strength: the ability of municipalities to fund public projects by paying investors below-market returns that are subsidized by tax exemption and unsecured guarantees (full faith and credit) to pay in case of default.

These exemptions grew out of the commerce clause of the U.S. Constitution and an 1819 U.S. Supreme Court decision (*McCullough v. Maryland*). That decision—which stated that the state of Maryland could not levy a direct tax on a branch of the national bank in Maryland—established the principle that federal, state, and local governments did not have the power to tax each other. Additionally, income from state and local municipal bonds could not be taxed if purchased within the same geographic area. These tax-equivalent total returns, along with Social Security and pension distributions, today form an important component of the overall retirement safety net.

## A Crisis-Driven Patchwork of Regulation

The friction between the federal government and individual states resulted in a peculiar patchwork of muni market regulation. In most cases, municipal securities rules have been carefully construed to avoid oversight conflicts with the states, and only passed when a crisis threatened to undermine investor confidence.

The Crash of 1929, for example, led to creation of the SEC and new federal regulation of the securities industry. Yet municipal securities, largely unaffected by the Crash itself, were exempted from the disclosure regulations of both the Securities Act of 1933 and the Securities Exchange Act of 1934.

In response to the New York City financial crisis, the Securities Acts Amendments of 1975 finally authorized the SEC to regulate municipal bond broker-dealers and establish the Municipal Securities Rulemaking Board (MSRB), similar to the National Association of Securities Dealers (NASD). Yet the Tower Amendment, authored by Senator John Tower (R-TX), was added to reinforce state sovereignty by preventing the SEC and MSRB from having supervision over state issuers.

The default of Washington Public Power Supply System led the SEC to adopt Rule 15c2-12, beginning in 1989, and with amendments over the next six years, to address primary and secondary market muni bond requirements. New underwriters in primary offerings of municipal securities of \$1 million or more were required to obtain, review, and distribute copies of the issuer's Official Statement (OS) to a Nationally Recognized Municipal Securities Information Repository (NRMSIR).

An OS, which is similar to a prospectus distributed prior to a corporate issuance, includes a description of the issuer, the purpose of the project being financed, a description of the security for the bond, any feasibility studies of the underlying project that are relevant to the issue, any contracts or obligations of the municipality that are either related to the issue or that might affect the issue, and a summary of the principal financing documents.

To review an OS, an investor had to obtain one from an underwriter or from one of the NRMSIRs, which charged investors a fee for the report. The MSRB also set up a reading room at its headquarters in Alexandria, Virginia, for on-site viewing of these documents.

In 1994-5, the SEC turned its attention to the secondary market. The new rules were designed to prevent fraudulent, deceptive, or manipulative acts or practices in connection with the underwriting of municipal securities by brokers, municipal securities dealers, and "participating underwriters." Rule 15c2-12 was expanded to bar underwriters from handling securities from issuers that did not agree to provide annual financial reports (similar to 10-Ks), as well as to require timely and ongoing reporting of 11 material events (similar to 8-Ks):

1. Principal and interest payment delinquencies;
2. Non-payment related defaults;
3. Unscheduled draws on debt service reserves;
4. Unscheduled draws on credit enhancement;
5. Substitution of credit or liquidity providers, or their failure to perform;
6. Adverse tax opinions or events affecting the tax-exempt status of the security;
7. Modifications to rights of security holders;
8. Bond calls;
9. Defeasances;
10. Release, substitution, or sale of property securing repayment of the securities; and
11. Rating changes.

As a result of Rule 15c2-12, underwriters began to include Continuing Disclosure Agreements in bond offerings. These sections served to hold municipal issuers accountable (and protect underwriters) for providing annual reports and material event disclosures. The language also exposed issuers to securities fraud liability under SEC Rule 10b-5 if their disclosures contained material misstatements.

The Tower Amendment continues to limit the SEC's authority over municipal bond-related disclosure and accounting rules. SEC Chairman Christopher Cox has stated that the disclosure rules between publicly traded securities and municipal bonds should be similar (*The Tower Amendment: Background and Potential Impact of Repeal*, an Executive Briefing for NASACT Members, March 16, 2007). He has not ruled out asking Congress to repeal Tower, which could have a dramatic impact on current financial management practices of state and local governments. History would suggest repeal of Tower would be blocked in Congress, but a major default or muni bond scandal in the next several years could change that.

## An EDGAR System for Municipal Bonds?

At the time the SEC was formulating and implementing Rule 15c2-12, the SEC was also creating EDGAR (a free, online information system) for corporate filings, but not for municipal bonds. Instead, under MSRB's Rule G-32, the managing or sole underwriter of municipal securities was required to send hard copies of an OS to all broker-dealers purchasing the new issue and to a NRMSIR and state information depository, if one existed. Reports of material events were to be sent either to one of four privately held NRMSIRs or to the MSRB and one of three state information depositories (SIDs). The SEC later approved amendments to Rule G-32 that permitted electronic distribution of OSs in lieu of paper copies, but hard-copy distribution remained the required disclosure method.

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The current environment for processing new issues and providing secondary market disclosure remains highly paper-intensive and manual, resulting in delays and errors that represent a growing area of risk. In addition, there are no standards for what constitutes good disclosure. The rule only requires sending documentation. It does not require verifying that the information is accurate or searchable.

Since 1995, private providers have attempted to step into the breach. Some have tried to help issuers meet Rule 15c2-12 filing requirements by providing a centralized filing center that redistributes information to the NRMSIRs and SIDs and gives investors a Web-based, CUSIP search portal to obtain information about specific bond issues.

Overall, these competing NRMSIR, SID, and privately owned systems and platforms have continued to frustrate retail investors, who may be used to retrieving information from EDGAR, downloading pdf-formatted prospectuses from mutual fund companies, and reading a wide array of analyst reports and opinions on publicly held companies. Laddered bond portfolios remain a staple retirement recommendation by investment advisers, yet few holders of these portfolios can say with any degree of clarity what bonds they are holding and what risks these bonds might entail.

A new system from The Depository Trust & Clearing Corporation (DTCC), expected later this year, may enable automatic capture and dissemination of information required for underwriting new issues. In addition, MSRB is currently seeking comment on draft rule changes to implement an electronic system for access to primary market disclosure in the municipal securities market, with implementation in 2008. This new electronic system would provide Internet-based access to OSs and other documents and related information.

The muni market should embrace these initiatives and anything else that will provide greater transparency and reduce the risk of onerous new legislation, whether through repeal of Tower or some other process.

## Disclosure of Unfunded Liabilities

In 2004, the Governmental Accounting Standards Board (GASB), an independent, not-for-profit organization, issued Statement 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. It requires state and local governmental employers to account for and report the annual cost of OPEBs. GASB 45 is effective in three phases based on a government's total annual revenues, with phase-in for the largest employers having begun in December 2006.

GASB 45 does not require governments to fund OPEBs, merely to determine their future liability. But few in the industry accept that at face value. According to a 2006 report from the Cato Institute, states and municipalities face \$1.4 trillion in unfunded promises for retiree health benefits, or three times more than all municipal debt issued in 2006. That amount of unfunded liability could raise Rule 15c2-12 material-impact issues across the muni fund industry. In addition, once underfunding is disclosed on a municipality's financial statements, failure to implement a funding plan could affect that entity's credit rating.

Some states have been considering legislation to block GASB 45 implementation, but a more prudent approach may be to embrace it. Once the future liabilities are known, issuers can work with their underwriters to disclose any shortfalls and structure new bond or trust offerings to fund future expenses.

The less-palatable alternative: If few municipalities conform to GASB, the SEC could recommend strengthening GASB or folding it into the Financial Accounting Standards Board (FASB) and FASB's much-tougher standards. (According to the NASACT Executive Briefing, the SEC believes it has oversight powers over GASB, based on the Sarbanes-Oxley Act.) Under FASB, unfunded liabilities would appear on the balance sheet as a liability, rather than as a footnote under GASB. The SEC could also require state and local governments to comply with Section 404 internal controls of Sarbanes-Oxley.

## Supreme Court

In May 2007, the Supreme Court agreed to hear a case from Kentucky (Department of Revenue v. Davis, 06-666) that questions whether states have the right to exempt interest on their own bonds from a resident's taxable income while taxing the interest on bonds issued by other states. In January 2006, the Kentucky Court of Appeals had declared the practice unconstitutional, saying the preferential tax treatment effectively erected a barrier against interstate commerce in violation of the Constitution's commerce clause.

As many as 42 states, including New York and California, give their own bonds special tax treatment, according to Bloomberg.com ("Municipal Bond Tax Breaks Draw High Court Scrutiny," May 21, 2007). The article notes that a ruling against Kentucky might force those states either to eliminate the tax breaks or extend them to out-of-state bonds. Elimination of the tax break could substantially increase the cost of borrowing in those states, reduce the value of outstanding municipal bonds, and eviscerate the appeal of mutual funds that hold securities from a single state.

An adverse decision during the Court's next term potentially represents yet another Rule 15c2-12 material event. The possible impact of such a decision should be considered for disclosure if for no other reason than as a deterrent against future investor and fund company lawsuits.



## A Shift to More Regulation?

On December 22, 2006, *The Bond Buyer* published an article entitled “Overshadowed Agenda,” which discussed the regulatory environment for the upcoming year. The article noted that “The Justice Department and the SEC are conducting parallel criminal and civil investigations and have subpoenaed dozens of firms—investment and derivatives brokers and providers, securities firms, banks, insurance companies, and others—for information about bond-related investment and derivatives transactions done during the past six to 14 years.”

These investigations into possible anti-competitive behavior, including collusion between firms to get business, bid rigging, and price fixing, appear fairly aggressive by today’s standards. But they may represent only the tip of the iceberg if either the next President or Congress favors increased oversight. This, when combined with the issues already discussed, could result in new legislation and newly emboldened regulators eager to distance themselves from the former, friendlier regime.



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## A Floor, Not a Ceiling

Transparency has obviously not kept pace with the extraordinary growth of the muni bond industry. Rule 15c2-12 did a good job of setting a floor, but it may be time to go beyond its minimal requirements and begin applying common-sense approaches to disclosure.

The Web site for the National Federation of Municipal Analysts lists 25 reasons to voluntarily disclose more information that may materially affect a municipal bond ([www.nfma.org/statements.php](http://www.nfma.org/statements.php)). To us, the most important reason is the one Senator John McCain, as chairman of the Senate Commerce Committee, gave to Donald Fehr, the head of the Major League Baseball Players Association on March 10, 2004, in response to baseball's inability to police the steroid controversy.

"Your failure to commit to addressing this issue straight on and immediately will motivate this committee to search for legislative remedies," McCain said. "The status quo is not acceptable. And we will have to act in some way unless the [players' union] acts in an affirmative and rapid fashion."



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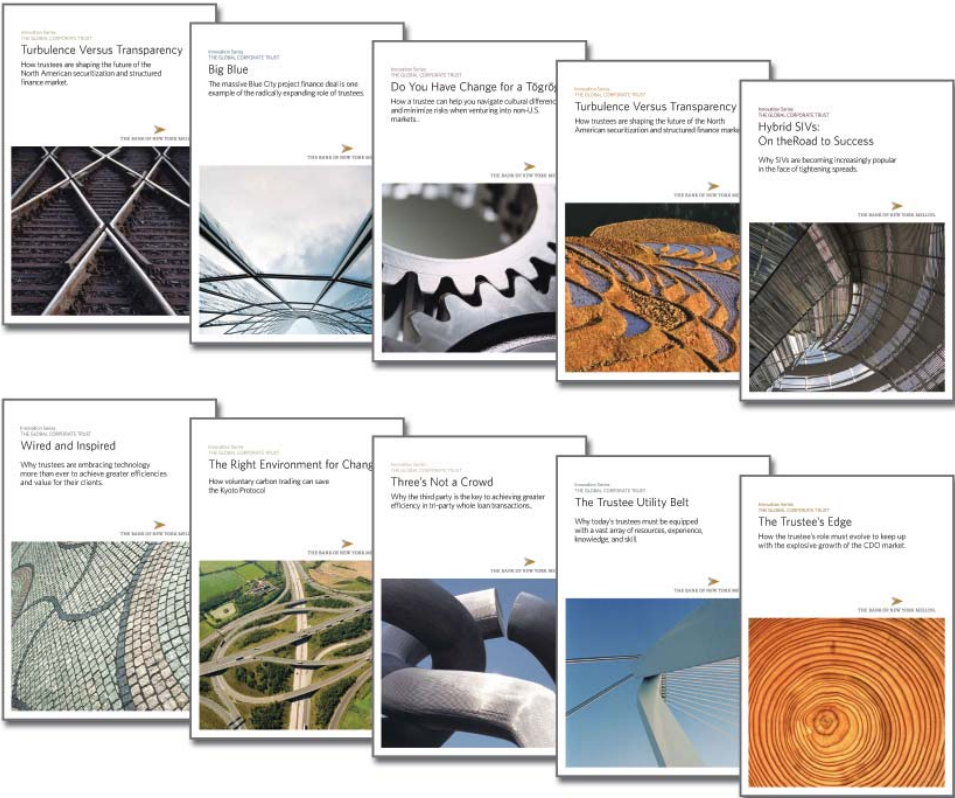
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# Who's Helping You?



Thanks to the efforts of issuers, underwriters, regulators, and rating agencies, the municipal bond market has enjoyed phenomenal growth. But at least five outstanding problems may form a perfect storm that will result in greater industry oversight. Self-regulation may offer the last chance to avoid new muni legislation. In this issue of the Global Corporate Trust Innovation Series, you'll discover how today's challenges and tomorrow's opportunities will have a critical affect on the evolution of the muni bond industry.

## Who's Helping You?



By Troy L. Kilpatrick and Antonio Portuondo



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