



Doty of AGFS Says “Smaller Issuers Are Heavily Reliant Upon Us”

This is Part I of a two-part interview with Robert Doty, President of American Governmental Financial Services, where he discusses his letter to Congress and the SEC supporting the regulation of municipal financial advisors.

MuniMarket Pulse Podcast

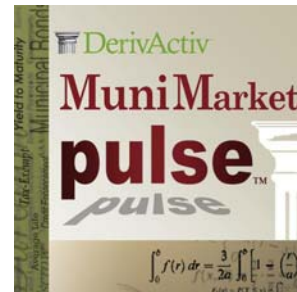
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Interviewee: Robert Doty, President, American Governmental Financial Services

Interviewer: Johan Rosenberg, President, DerivActiv, LLC

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Episode Transcript: Robert Doty PART I

Johan – Let’s get right to the heart of the matter here. On April 15 you wrote a letter to Congress and the SEC, to Barney Frank and Mary Shapiro where you gave your insight into the support for the idea of regulating advisors in the tax-exempt capital markets, tax-exempt bonds and those are market participants who are currently unregulated. Maybe you can first give us some insight into the role that this particular professional has in the industry and why you think they're so important?

Robert – The market consists of a very large number of issuers and they vary widely in term so of their size and their sophistication. A substantial amount of bonds are issued by a small number of issuers. Difficult to try to pin numbers on that, I've heard various estimates. I think it's fair to say that the large issuers really do dominate the market in a major way. On the other hand there are tens of thousands, literally, of small issuers consisting of cities, counties, school districts, various types of special authorities and agencies.

Johan – Then we have the conduit borrowers too.

Robert – There are also conduit borrowers. The borrowers have to borrow through an issuer so there are private companies involved and they themselves vary according to their size and sophistication and credit quality and so on. We have had some spectacular problems with a few large issuers. New York City in the 1970s, WPPS in the 1980s, Orange County in the 1990s, San Diego in this decade and now we're taking a look at Jefferson County, Alabama, which was engaged in interest rate swaps in connection with its bond issues. Nevertheless there are many, many troubled small transactions ranging in size from a few million up to maybe tens of millions at least. Those are often issued by small, local governments where the issuers really did not have the ability to understand the financial issues that were confronting them involving private parties, credit issues, various transactions that might have been too complex for them. Sometimes there

are tax issues that they don't understand. Frankly while it's kind of fashionable for some people to shake their head and wag their finger at these small issuers and say, “Well these people shouldn't be engaging in transactions they don't understand and they should be asking questions and so on,” my view is that in many cases it's not feasible for these people ever who run these small issuers, ever to become fully sophisticated or even appropriately sophisticated. They involve local citizens off the street. People who get mad because potholes aren't being filled, people who have sometimes civil rights issues, people who want to improve schools, but they're not finance people.

Johan – But if they want to borrow in the capital markets they nonetheless have to face these sophisticated issues. I mean even the simplest borrowing has difficult to understand financial concepts embedded in them.

Robert – Exactly. I suppose we could identify some of these people who might be qualified to go to college and study finance and go on to take graduate courses, but you can see just from the way I'm describing it, you're talking about something that requires years of effort to really get your arms around, and they don't have that kind of time. Then when they're sitting on a board or city council or something like that, they have literally hundreds of issues that come to their attention. They have citizens who are calling them all day, everyday, every time they go out to eat a sandwich somebody is grabbing their arm so now we're going to ask them to become finance experts, well they can't. So the question is who is there to help these people? Now one possibility is the underwriter, but if you are familiar with any litigation in this area, you'll know that anytime an underwriter gets sued, their first defense is, “Oh I was a dealer dealing with you at arms length in commercial buyer-seller transaction and I owe you no responsibility.” In fact, the Securities Industry and Financial Markets Association (SIFMA) has a draft model bond purchase agreement that makes it absolutely clear that underwriters are dealing as principals, solely as principals, in commercial buyer-seller transactions and that they owe absolutely no fiduciary duties to the issuer. The underwriters say, “Whatever I said to you, you had no right to rely on that.” In other words suddenly the underwriter is sort of like a used car salesman. That argument has been upheld judicially. The argument is well you may be a small issuer, that's true, you weren't sophisticated, that's true, but you still had no right to rely on the underwriter who was dealing with you solely as a principal. There needs to be somebody whose role is defined as being with responsibility to the issuer. These issuers need it. The very large issuers probably don't. They might use a financial advisor as a sounding board. But these medium sized and especially smaller issuers are heavily reliant upon us.

The concept of a financial advisor is one that is not specifically defined very well, certainly not in statutory law and not judicially. But in reality there are many different kinds of service providers who provide important financial advice to issuers in connection with the issuers' decisions on whether to proceed with bond issues or whether to use particular structures in bond issues. For example there are firms that use the label “financial advisor” when they are employed, and these firms include both dealers and non-dealers. One area where I disagree with some non-dealer firms is as to whether dealer firms can be financial advisors. I see absolutely no reason why not. They certainly are employed currently as such. I think some of the dealer firms are really quite good in providing financial advice, and I think they are perfectly capable of being independent in a particular engagement, that is they do not have conflicts of interest in that

engagement. Both dealer firms and non-dealer firms really should be subject to this regulation. The dealer firms themselves ought to make sure that their personnel are qualified, that they have continuing education and so on. But there are other service providers as well. Some of the non-dealer firms argue that swap advisors are not financial advisors, but I consider that argument to be just silly. A swap transaction is a major financial transaction for an issuer and quite commonly, if not generally, it is a transaction that is closely associated with and an integral part of a bond issue. Other service providers are involved as well. There are many, many types of firms that provide financial projections for issuers that show future cash flows based upon, projected based upon assumptions. These are commonly called feasibility consultants, but these services may be provided by the typical non-dealer firms, they maybe provided by accounting firms, they may be provided by engineers. They may be provided by people who are just operating out of their basement and who develop what they call studies or reports, and they prepare financial projections. In addition another type of firm is an appraisal firm. These firms will appraise assets, they will appraise land and other assets that provide security to issuers in connection with bond issues, either securing the bond issues directly or securing the issuers in terms of the source of revenue. All of these firms provide financial advice to issuers that the issuer's take into account in deciding whether to proceed with bond issues and in deciding to use particular structures. I believe all of these firms should be subject to regulation.

Johan – The thing about the underwriter too is that they serve the investor client as well.

Robert – Exactly.

Johan – And they have that dual role and I'd like bring up a recent conversation that I had last week which maybe highlights the conflict that an underwriter might have in its serving of a borrower, an issuer. It was with respect to some Build America bonds where I was talking to a Wall Street underwriter and I was telling him that a regional investment bank, one of his competitors, had successfully sold one of these Build America bonds with a serial bond structure, a 10 year call at very fair rates. I almost fell over backwards with the response from the Wall Street firm who said, "Well I'm not going to participate in that." I said, "What do you mean?" He says, "Well I'm not going to participate in ripping off my investor clients with that type of structure and that rate." And my response was, "Well that doesn't sound too borrower-focused, your response." And he quickly backtracked, but I feel like he just had the ultimate Freudian slip. Maybe that's the heart of the issue or it brings to the point where you need to have someone who just represents the borrower. Maybe you can go into that a little bit.

Robert – Let me start by saying you refer to it as a dual role of the underwriter. I don't agree with that. I don't think the underwriter has a dual role if they perform their task appropriately. Sometimes though they mislead the issuer, sometimes they tell the issuer they're going to advise them, and then they really create a problem because I don't see how the underwriter can possibly be an advisor to the issuer and also be looking out for the investors' interest under FINRA rules, under traditional market concepts. The dealer's responsibility in selling these securities to the investor is to give the investor the best transaction they can.

Johan – Well that's not how they sell the story to the borrowers, right?

Robert – No, they don't sell that story to the borrowers, but that's because you have to understand within the firm, within the same firm, there are of course different individuals in different departments. I've been in some of these departments as an underwriter. I've been an underwriter, and you have to depend on your relationships with the issuers in order to get the underwriting role. But on the other hand you've got dealers, brokers, you have a trading desk, an underwriting desk, who have a very different function and they almost never even see the issuer, or even talk with them, much less feel a responsibility to them. Their responsibility is clearly to the investor and that's how they see it. But the people who are investment bankers going out contacting the issuers feel that they have to "look out for the issuer." I've seen that with a major underwriting firm where the individual on the front line said, "I don't care what my firm says about responsibility to the investor, my client is the issuer." But I can assure you if any issuer ever sued them, that's not what the firm would be saying. So there isn't anybody who looks out for the issuer in the financial sense in terms of being obligated to do so and having that responsibility.

Johan – OK so let's juxtapose that now to the financial advisor--that is their sole and only function.

Robert – That's what it's supposed to be. There are advisors who don't see it that way. They don't look out for the investors, but I've seen a number of situations where there are financial advisors who come in, get hired as a result of being referred by private parties--for example an assessment district or mello roos district, a special tax district that is here in California, a conduit transaction, a non-profit or for profit making--they get introduced and they kind of look out for that private party sometimes and get into a conflict situation. They also have other conflicts that they introduce themselves. So it's not always as pure as you would like it to be. In its ideal sense, the financial advisor can be a real boon for an issuer, be a really helpful party. But unfortunately there isn't the necessary attention to avoiding conflicts of interest in order to get that done.

Johan – Let's switch a little bit over to the National Association of Independent Public Financial Advisors. That's something that you were a member of the governance of in the past. Now you seem to be in disagreement with their current statements with respect to advisors being regulated, i.e. they're against it and you are generally speaking, for it. So maybe we can talk a little bit about that. They make some claims about not being swap advisors and they're not bond dealers, and they don't have any conflicts of interest. You don't agree with them right now.

Robert – That's right. I never agreed with them on that. When I was on the Board I raised these issues, and I was trying to move it forward to make progress and trying to get people to focus on these issues. I haven't changed any opinions from the time that I was a member and on the Board to now, it's just that now I no longer can speak as a member of the Association or on the Board, so I'm speaking out publicly.

Johan – Okay. What's the main thrust that causes them to disagree with regulation of their constituents, besides the very public statements they've made about swap advisors and not being a bond dealer, what's the fundamental reason they don't want to be regulated?

Robert– I think they feel the same concerns I do. I'm nervous about some of this stuff. I wouldn't be speaking frankly if I didn't say that. I don't like the idea of having somebody looking over my shoulder. I don't like the idea that I might have to incur some costs that I don't have to incur now. And then I think there's a third area--this was brought up by the Municipal Securities Rulemaking Board, which is a dealer self-regulatory organization. There has been a sense of rivalry between quite a few dealer firms and quite a few non-dealer firms who are in the financial advisory business. Because sometimes dealer firms provide financial advisory services too. And I think that there is concern that the dealers would use the regulatory lever to essentially raise the costs of regulation for non-dealer firms to a level that's unjustified and that would make it very difficult for a firm to even to be a non-dealer firm.

Johan – So it's the establishment of a hurdle a barrier to entry into the market or a barrier to operate in the market that would basically lessen the amount of financial advisory participants, that's one worry.

Robert – That's one worry. I've raised a fourth worry which NAIPFA never raised, and to me it's the most important one. And that is because the dealers are also underwriters, in effect, and as underwriters as we've just discussed they are adversaries of the issuers in the transactions on matters of price, terms and so on. As the quotation I just gave a few minutes ago from the Securities Industry and Financial Markets Association draft model bond purchase agreement illustrates, it would mean that my clients' adversaries would be regulating me performing my duty for my client. And to me, of all of the concerns: cost, interference in my business, regulation by someone who might be a competitor and who might want to make it difficult for me as a small firm to continue to operate, this is more important than any of those.

End of PART I

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