

Frank-Dodd Wall Street Reform and Consumer Protection Act Means No Longer Business as Usual for Kansas Local Units of Government

On July 21, 2010, President Barack Obama signed the “Frank-Dodd Wall Street Reform and Consumer Protection Act” (the “Act”) into law. The Act was a legislative response to the world financial crisis that initiated in 2007 and continues today. Several provisions of the Act may affect Kansas Local Units of Government (“municipalities”). The provisions I will focus on are those that affect how municipalities borrow and invest money. More specifically, it’s the registration requirement and the implications of such a requirement, as made by the Securities and Exchange Commission (“SEC”), and Municipal Securities Rulemaking Board (“MSRB”) of those advising on how to borrow and invest public dollars, called Municipal Advisors.

In my opinion, the basis of the registration requirement for Municipal Advisors stems from abuse of the investment of bond proceeds. The “Tax Reform Act of 1986” restricted a municipality’s ability to arbitrage (a nice way to make money without working very hard!). Municipal entities were also required to invest these bond proceeds by a competitive process; this was not always done. There have also been accusations that some Municipal Advisors were retained by municipalities because of political donations rather than by merit. The abuses on the debt side have been mostly associated with the issuance and re-marketing of variable rate debt. Section 15B of the Act describes how the MSRB, under the auspices of the SEC, will protect Kansas Local Units of Government, i.e., registration is required of Municipal Advisors.

The U.S. Securities and Exchange Commission headquarters located at 100 F Street, NE in the Near Northeast neighborhood of Washington, D.C.

Who's a Municipal Advisor?

Under Section 15B of the Act, a Municipal Advisor is defined to include a person, who is not a municipal entity or an employee of a municipal entity, who provides advice to or on behalf of a municipal entity or obligated person with respect to the structure, timing, terms and other similar matters concerning such municipal products or securities issuance. All items relating to the investment of public funds including derivatives, guaranteed investment contracts, and investment strategies are municipal products. Revenue bonds, general obligation bonds and leases would be considered securities. Since cities and counties in Kansas have to issue bonds to obtain a United States Department of Agriculture ("USDA") loan, then a USDA loan would be considered a security, too.

A Municipal Advisor was to be registered with the MSRB as of December 31, 2010, and with the SEC as of October 1, 2010. You may verify that the individual or the firm that the individual is employed by is registered by checking the these Web sites: 1) www.msrb.org and www.sec.gov.

Being designated as a Municipal Advisor, however, is not just a matter of registering with the MSRB and the SEC. The MSRB is required to (a) prescribe means reasonably

designed to prevent acts, and courses of business inconsistent with a municipal advisor's fiduciary duty to its clients (this means to put the interest of the clients over your own); (b) provide continuing education requirements; (c) provide

professional standards and (d) not impose a regulatory burden on small advisors. Item (d) was to prevent the MSRB from making rules that would create an undue burden on small financial advisory firms – I have already complained. If the rules get too burdensome, then small firms will either have to merge with other firms that have compliance officers or go out business. In either case, competition amongst financial advisors decreases and the cost of borrowing increases for municipalities.

The activities that require an individual to be registered as a Municipal Advisor, again, are:

providing advice regarding the structure, timing, terms and other similar matters regarding municipal products or the issuance of municipal securities. "And other similar matters" seems to be a catch-all phrase. It is my opinion that "and other similar matters" should include providing municipalities options and advice regarding how to best finance projects or invest funds. To me, this advice is at the heart of being a financial advisor. While providing options

Municipal entities and their employees are not subject to the Municipal Advisor definition because it is assumed that they do not have a financial interest in how debt is issued or how funds are invested.

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for the investment of dollars is covered by the definition of a Municipal Advisor, the providing of options for debt financing is not. While providing financing options alone may not make an individual a Municipal Advisor, if that information leads to a decision by a municipality on a financing method, then that individual has acted as a Municipal Advisor. The only individuals that should be an exception to these rules are bond attorneys (as further explained below).

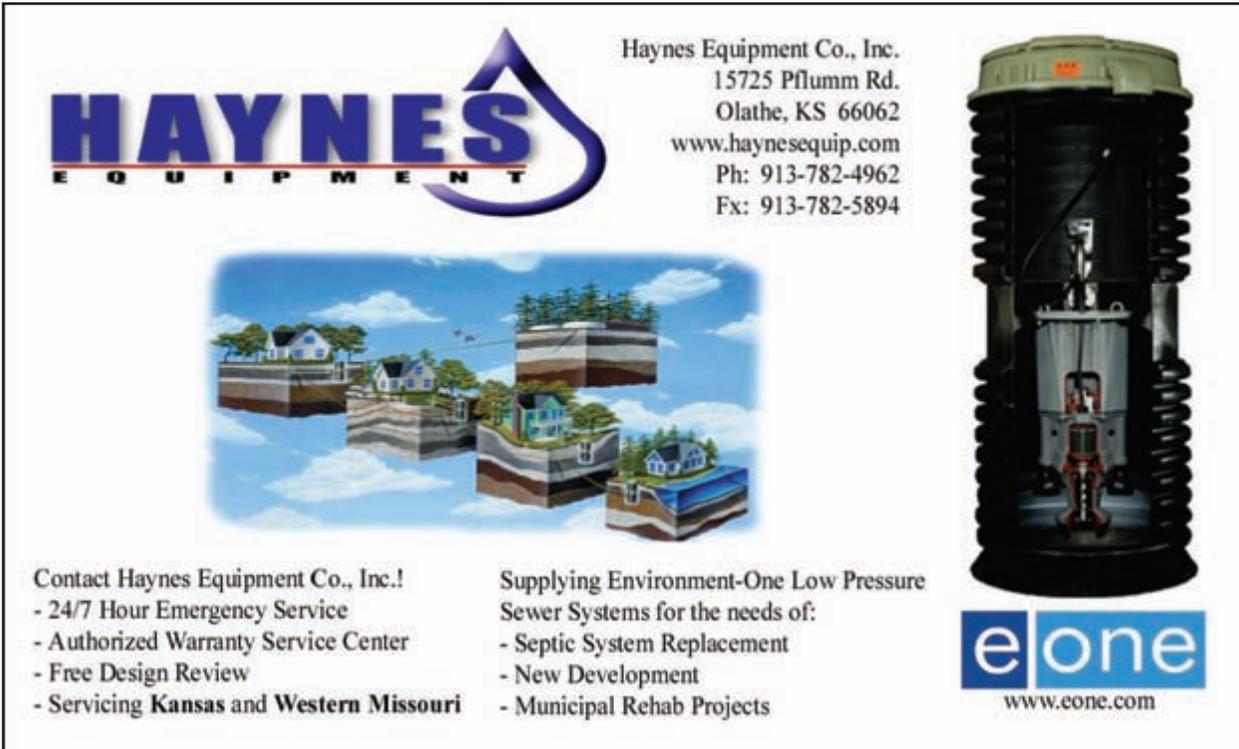
Exceptions to the Municipal Advisor definition are: 1) municipal entities and their employees; 2) dealers serving as underwriters; 3) SEC registered investment advisors and their associated persons; 4) attorneys offering legal advice or traditional legal services; and, 5) engineers providing engineering advice. Municipal entities and their employees are not subject to the Municipal Advisor definition because it is assumed that they do not have a financial interest in how debt is issued or how funds are invested. However, if an employee of a municipality is providing advice regarding the issuance of debt or investment of funds, should that person not also demonstrate the knowledge base to provide this information? It seems that because of these mandates by the SEC on the MSRB, there should be a knowledge base on giving financing and investment advice – employee of a municipality or not.

Securities dealers serving as underwriters are not considered Municipal Advisors because a dealer recommends an investment or debt financing based upon selling the investments or purchasing the debt financing. A

dealer does not have the fiduciary responsibility to provide the best investment or debt financing options, but to properly disclose the terms of the transaction. However, to continue to work with local units, dealers should provide good service at reasonable rates and fees. Investment advisors and their associated persons are already registered and governed by the SEC rules and regulations.

Attorneys do not have to register as Municipal Advisors as long as they only provide legal advice. The SEC in its Release No. 34-63576 (the “Release”) expounds on its definition of what constitutes legal advice. “Generally, the Commission interprets advice provided by a lawyer to its client with respect to the structure, timing, terms and other similar matters concerning municipal financial products or the issuance of municipal securities to be services of a traditional legal nature... However, advice which is primarily financial in nature, such as advice which is primarily financial in nature, such as advice concerning the financial feasibility of a project or financing, advice estimating or comparing the relative cost to maturity of an issuance depending on various

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interest rate assumptions under prevailing market conditions, would be primarily financial advice and not services of a legal nature.”

Engineers working on a municipality’s project are often asked how to best finance the project, either by issuing debt or generating additional revenue by some other means. The Act provides certain exceptions to engineers, just as with attorneys. The Release also explains what the SEC considers traditional engineering services:

“With respect to engineers, the exclusion applies to engineers providing engineering advice.” An example of an activity that falls under the “exclusion” would be costing out engineering alternatives. Some activities not under “exclusion” would be cash flow modeling of the cost of the project, discussing the cost of financing and the cost of other financing alternatives, advising which option is better or complete feasibility studies on the project(s) which are required to be financed.

The Act does not contemplate regional planning commissions (“RPC’s), economic development commissions and certain other entities as a Municipal Advisor. These organizations may recommend financing projects with USDA loans or KDHE revolving loans. It is clear that these organizations are giving financial advice, but not clear as to whether or not they are required to be registered. I would say that it is fairly clear that these organizations would not be allowed to estimate debt service, perform rate reviews based upon project financing or perform financial feasibility analysis based upon the SEC’s Release concerning engineers.

An obligated person is an entity that has municipal debt that is issued on its behalf, which would include companies or hospitals that have Industrial Revenue Bonds, (IRBs) issued on their behalf. I would also assume that if a Public Building Commission (PBC) issues revenue bonds to finance a project for the benefit of a city, county or hospital, then the entity that benefited from the issuance of those bonds would also be considered an obligated person. Rural water districts financing projects through the Kansas Rural Water Finance Authority (KRWFA) or any entity financing a project through the Kansas Development Finance Authority (K DFA) would be considered an obligated person. This is where the Act gets a little crazy. Mintz Levin, in its Public Finance Alert,

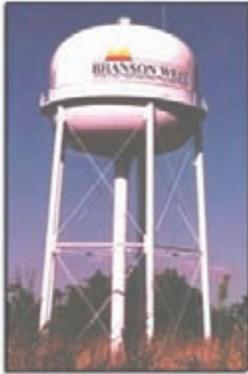
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January 3, 2011, states the SEC would “require appointed board members of a municipal bond issuer or other municipal entity that invests governmental funds to register as municipal advisors with the SEC and the MSRB if they provide ‘advice’ to the municipal entity as to the issuance of municipal securities, swap transactions and/or investment strategy relating to state or municipal funds.” For the time being, or until it is clarified or changed, chief financial officers of

corporations or hospitals and board members of local PBCs would be considered Municipal Advisors if they recommend the issuance of revenue bonds to municipalities, and would consequently need to be registered. Mintz Levin suggests that this might be cleaned up with the final rules, but they also suggest that one is walking on thin ice regarding securities laws until it happens.

The biggest concern I have regarding the Act was information as reported by McGuire Woods, attorneys, in its Legal Updates, dated July 22, 2010. McGuire Woods reports that “Dodd-Frank (the Act) directs certain federal agencies to conduct studies of aspects of the municipal securities market and to submit recommendations to Congress for improving current law.” Congress specifically has requested that the SEC make a recommendation as to whether Congress should amend or repeal Section 15B(d) of the Securities Exchange Act of 1934, as amended (Exchange Act), also commonly

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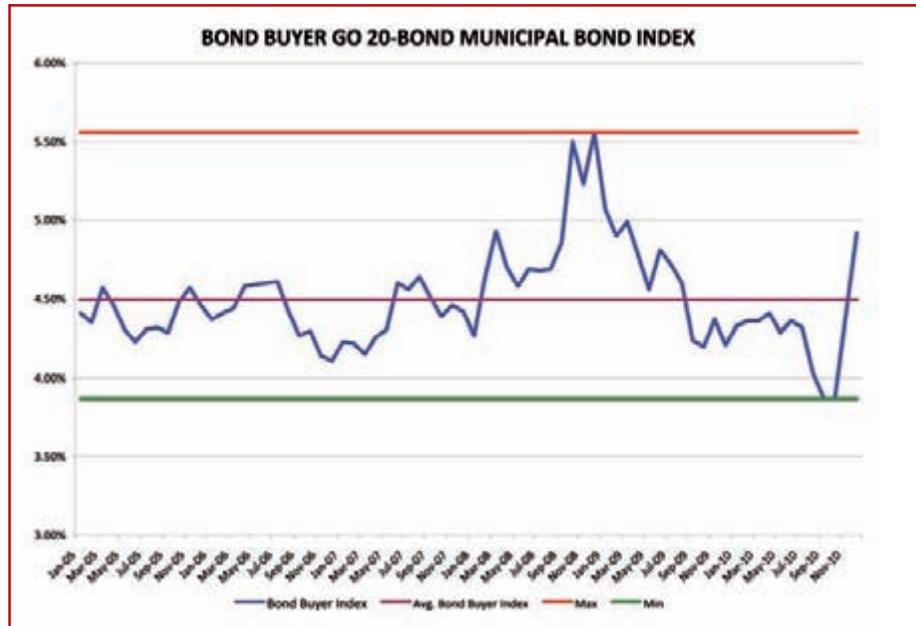
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known as the Tower Amendment. The Tower Amendment basically exempts municipal bonds from being registered with the SEC. This change will definitely increase the cost of borrowing for municipalities. Small municipalities may no longer be able to access the municipal bond market.

An ancillary byproduct of the Act that will affect municipalities is the potential change to Rule G-23 of the MSRB. This rule has to do with the ability of securities dealers to act as financial advisors. On May 7, 2010, SEC Commissioner Mary Schapiro made this statement: "Financial Advisors should be prohibited from resigning as financial advisor to an issuer, and then underwriting the issuer's bonds, as they are currently allowed to do under MSRB Rule G-23. Right now, a financial professional advising a municipality can guide the municipality towards securities tailored to his firm's advantage, then resign and act as underwriter. This is a classic example of conflict of interest." Some dealers have stated this would reduce competition for the bonds. I agree. One recommendation would be not to hire a dealer as a financial advisor, so competition for bond issues would not be reduced. In Kansas, however, there are very few independent financial advisors. Dealers often take up this slack. In addition, there are certain dealers that have an expertise in particular types of bonds issues in Kansas, particularly school finance.

The bottom line is if your municipality has questions regarding the structure, timing and terms of an investment or debt financing, make sure you are working with a registered Municipal Advisor. Not only is it the law of the land, but only a registered Municipal Advisor has the demonstrated expertise to provide you the proper advice to invest and borrow money. That is the intent of the SEC and the MSRB.



Municipal Market Update

Professionals in the field of public finance often track interest rates based upon the Bond Buyer General Obligation 20-Bond Index (the "Index"). It is an index of the interest rate on twenty actively traded, general obligation bonds. The Index can be thought of as the Dow Jones Industrial Average in the world of municipal bonds. A chart of the Index since January 2005 is included in this article. Since January 2005, the Index has ranged from a high of 5.56% in December 2008 to a low of 3.87% in September and October 2010. The Index has also averaged 4.50% since that date. As of December 2010 the index is 4.92%. Your municipality was very lucky, or your municipal finance professional was very good, if debt was issued for your municipality in September or October 2010. There have been a number of reasons cited regarding why interest rates increased from 3.87% in 4.92% in less than two months. The three most discussed reasons for this include: 1) the end of the Build America Bond Program ("BAB's") on December 31, 2010; 2) perceived inflation; and, 3) forecasted massive defaults by municipalities.



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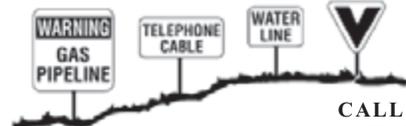
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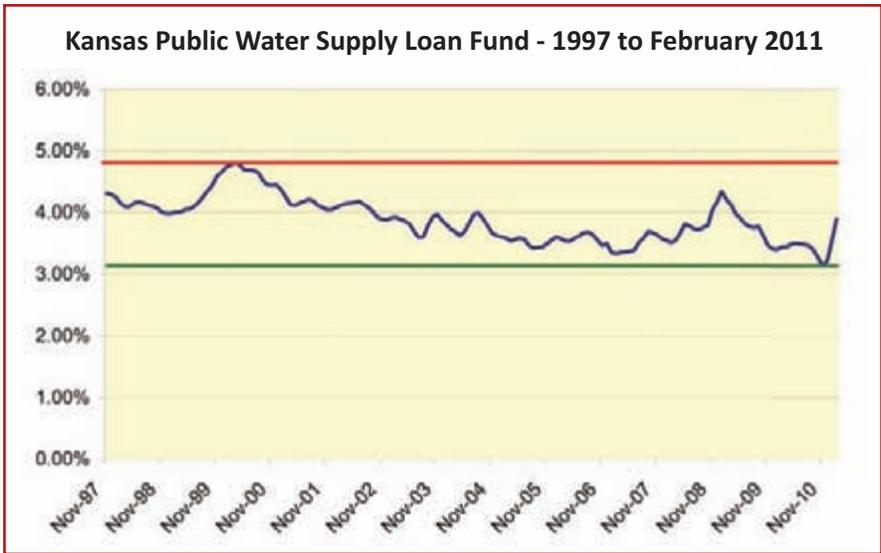
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Municipal Bonds was 4.92% for approximately the same date). The difference between 3.55% and 4.92% represents an annual savings over \$9,000 per \$1,000,000 borrowed over twenty years – at total savings greater than \$180,000 over the twenty-year life of the borrowing. For rural water districts required to issue revenue bonds, the savings is even greater – probably more than \$12,000 annually per \$1,000,000 borrowed over twenty years. Plus the Loan program only has a one percent loan origination fee. Assistance with the Loan Program is also without cost. Please contact Rose Mary Saunders or me at 316-264-3400 if we can be of assistance to you in obtaining a loan.

Interest rates for the Kansas Public Water Supply Loan Fund have ranged from a low of 3.33% in February 2007 to a high of 4.31 in November 1997. As of December 31, 2010, the Fund had made 214 loans totaling \$457,988,545; 152 of those loans totaling \$182,406,491 were made to borrowers serving fewer 5,000 or fewer population.

The Kansas Public Water Supply Loan Fund

If a city or rural district is seeking for a water system project, the Kansas Public Water Supply Loan Fund (the “Loan Program”) is a good option. The interest rate as of January 2011 for the Loan Program was 3.55% (a great interest rate; remember the Bond Buyer Index of 20

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