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The Muni Advisor Business: A Story of Explosive Growth and Change

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WASHINGTON — The municipal advisory business has exploded over the past 30 years, as economic, regulatory, and technological developments have combined to create a bigger business that is increasingly dominated by firms focused mostly on MA services.

While financial advisors have worked with municipal issuers for many years, the business transformed enormously during the three decades leading up to the Securities and Exchange Commission's adoption of its final MA registration rule in 2013.

That rule, and the associated MA regulations written by the Municipal Securities Rulemaking Board, implement provisions of the 2010 Dodd-Frank Act that for the first time subjected MAs to federal regulation and imposed a fiduciary duty on them to put the interests of their state and local government clients ahead of their own.

But while MA regulation represents a pivotal time in the history of the financial advisory business, radical changes were already well underway before the financial crisis that led to Dodd-Frank.

According to data from Thomson Reuters, only $9.7 billion of long-term bonds were issued with a financial advisor in 1980. By the end of 1985, when deals were rushed to market to beat implementation of the tax-exempt bond restrictions in the Tax Reform Act of 1986, that number had jumped almost nine fold to $86.3 billion.

Following a drop in the years after tax reform and the stock market crash of 1987, the par value of bond deals with advisors continued to trend sharply up after 1991. It was $104.8 billion in 2000, $257.9 billion in 2005, and $331.8 billion in 2010.

In 1980, issuers had advisors on only 21.4% of the total par value of bonds issued. Last year, 81.8% of the par value of bond deals had FAs.

Practitioners with longtime experience in the field said the explosive growth of FAs has been spurred by economic issues, technological changes, and shifts in issuer attitudes.

"The cost of doing a bond issue has shrunk significantly," said Keith Curry, a former managing director with non-dealer MA giant Public Financial Management. Curry, who is now a member of the Newport Beach, Calif. city council and a visiting professor at Concordia University in Irvine, said that technological advancements such as the Internet totally "changed the game" so that some of the broker dealers that dominated the business 30 years ago lost their grip on the business.

"It was certainly a business dominated by Wall Street investment banks," Curry said.

Changes in Rankings

The annual FA rankings by par value of bonds reflect a shift in the balance of financial advisors, away from traditional New-York based giants and towards firms that are either totally dedicated to, or place great emphasis on, municipal advisory services as a key part of their businesses. While firms like PFM and FirstSouthwest have had strong positions within the advisory industry going back to 1980, others have vaulted into the top 10 with the declining position of underwriter-first firms.

Wall Street and foreign financial service giants had a strong showing in the 1980 top ten by par value of bonds, with Swiss-based dealer UBS Securities taking a close second behind Dallas-based FirstSouthwest. Merrill Lynch, JP Morgan Securities, Wells Fargo & Co., and Citi were also among top 10 financial advisors. Goldman Sachs and RBC Capital markets joined the top 10 list at various times over the next several years.

That dynamic began to shift in the late 1980s, a development some sources attributed partly to large banks streamlining their operations in response to a two-year financial downturn following the Black Monday stock market crash on Oct. 19, 1987.

By the mid-1990s, PFM and Public Resources Advisory Group -- two non-dealer advisors -- had established themselves as the perennial industry leaders. From 1999 onward those firms joined FirstSouthwest, a dealer firm that has always had a large advisory business, to form the top three FAs by par value of bonds.

Robert Lamb, partner and president at Fairfield, N.J.-based Lamont Financial Services Corp., also said technology was a major transformative influence as the advent of accessible pricing services reduced the data resources advantage long enjoyed by dealer firms.

"We're able to look at most of the same data that the underwriters do," Lamb said.

John White, the chairman of PFM who has more than 40 years of muni industry experience, said that for many years issuers saw no reason to spend money on a financial advisor because they believed that their underwriter would offer them any advice they needed. More specialized advisory practices had to actively persuade issuers of the benefits of having an FA on the deal.

"It took a while for that to get accepted," White said. "Now you almost have an institutionalized presence of an FA in the deal."

Many market participants have said that the role of advisors could become even more institutionalized by the MA rule because of an exemption that allows underwriters and others to provide unfettered advice to a municipality as long as the issuer retains and certifies that it will rely on its own independent registered municipal advisor, or IRMA. The IRMA exemption is emerging as a key way for underwriters to protect themselves from having to register as MAs and losing their ability to underwrite bonds as a result.

Compared to 30 years ago, many issuers are now more aware of the conflict of interest inherent when a financial advisor also intends to underwrite the bonds they advise on - a conflict that became apparent in the debates surrounding the MSRB's Rule G-23.

Prior to 2011, Rule G-23 on activities of financial advisors allowed dealers to advise a state or local government to issue bonds and then formally resign that role to become underwriter of the bonds. The rule was revised to prohibit that practice.

Robert Doty, a lawyer and former financial advisor who now runs his own litigation consulting firm AGFS in Annapolis, Md., said that one common practice for decades was for a dealer to pitch its services as an FA and not even mention underwriting, even though the firm's overwhelming focus was to eventually underwrite the bonds.

"There were geographic regions where few firms said, 'We're an underwriter,'" Doty said. "They always said, 'We're an FA.'"

He said the MSRB deserves credit for changing the practice.

Complexity and Size of Deals

Several sources said that the mounting complexity and size of muni financings over the years pushed more issuers to seek financial advisors skilled in those kinds of deals. Relatively straightforward general obligation and project revenue bonds were joined by complex municipal derivatives and other more sophisticated structures, leading to the rise of swap advisors in 1990s.

Peter Shapiro, managing director at South Orange, N.J.-based Swap Financial, an MA as well as a registered swap advisor, said that firms like his were formed to cater to issuers doing complex swap deals. But the firm has broadened its reach as the interest rates swap business as declined.

"Since the financial crisis, firms like ours have been called upon to advise our clients not just on swaps, but on bonds," Shapiro said.

Shapiro said these advisors have extra credibility on certain deals, such as those that feature some portion of taxable debt.

"There's a need for some additional expertise," Shapiro said.

Shapiro said his own firm has also moved into providing advice to major endowments like those maintained by large universities.

"That's a growing client base for us," he said.

Michael Bartolotta, vice chairman at FirstSouthwest, said that issuers increasingly began to rely on advisors because deals became larger and more complicated. A larger transaction could justify the added cost of an MA on the deal, he said.

"I think it's complexity of product, Bartolotta said. "I think it's the sheer size of the transaction."

White said that during the 1990s more issuers also began to use advisors to help them with the investment of their bond proceeds, which became more complex and important after the 1986 Tax Reform Act required municipalities to track the investment income earned on muni proceeds and rebate to the federal government amounts earned in excess of the yield on the bonds.

Doty said the advent of MA regulation, which applies equally to dealer and non-dealer firms as long as they give bond advice to municipalities as advisors, is "a pivotal time" in the municipal market. The latest regulatory developments have the potential to make a huge positive difference in the industry, but execution by the regulators will be key in making that happen, he said.

"I hope in my lifetime to see this go into effect," Doty said of the MSRB MA regulatory framework that is still evolving, as well as SEC and Financial Industry Regulatory Authority enforcement. "It's going to be up to the regulators to bring these unruly advisors along."

While he stressed that many "really good, conscientious" MAs exist among both dealer and non-dealer MAs, Doty said there are also many incompetent or unqualified FAs that may have to fold their tents soon after the MSRB's qualifications exam comes out and regulation is effective. Issuers often look to their advisors to lead the transaction team, and some of them are not qualified to do it, he said.

"Often times, one of the least competent members of the team is in charge," he said.

Doty also is concerned about the "contingent fee" payment model for MAs. Hourly and fixed-fee structures have been used by numerous firms since the 1990s, Doty said, but contingent fee structures in which the advisor gets paid based on the closing of a deal is a serious conflict of interest. The advisor is incentivized to close the deal, especially after putting many months of work into it. Doty said that issuers should be: aware of that conflict; offered alternative fee structures; and be given the right to choose a different fee structure if they want one.

There is a huge need for MA services in the future, Doty said. "There are so many issuers that need competent advice from competent advisors," he said.

Some of the provisions of Dodd-Frank intended to protect issuers are still taking shape as the MSRB works to finalize its MA rules, especially its proposed Rule G-42, which will govern the core conduct of muni advisors. MSRB chair Kym Arnone has said repeatedly that completion of the board's muni advisor rulemaking is a top priority. The SEC must also approve those rules.
