ROCKFLEET
financial services
Volume 1, Issue 32

MUNI MARKET UPDATE

October 18, 2010

INSIDE THIS ISSUE:

RATING AGENCY REFORM

Louise T. Gantress

Trust is key to the bond business, and trust is predicated on credibility.

Relatively recent events in the asset backed security ("ABS") market shocked the financial system and focused attention on the failure of rating agencies to correctly assess risk. Unsophisticated investors lacking the specialized expertise necessary to assess an investment vehicle outsourced their responsibility to investigate and determine risk.

A rating is a powerful tool, but only one of many. Investors operated under the assumption the rating agencies understood the ramifications of the Gaussian copula

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MARKET UPDATE

Key regulators in the UK and the US said a global, coordinated effort is needed to ensure the failure of a major financial institution does not result in the type of catastrophe caused by the collapse of Lehman Brothers. "International coordination is critical to ensure that efforts to promote safety and soundness in one major financial jurisdiction are reinforced and not undermined by other jurisdictions," said Lael Brainard, undersecretary for international affairs at the US Treasury Department.

When they last met three weeks ago, several Federal Reserve policymakers agreed that they probably would need to restart a program of buying U.S. Treasury securities and debated ways to lift the public's expectations for future inflation, say minutes of the policy meeting. The minutes, released last Tuesday, showed policymakers were somewhat divided, but most thought new measures to jump-start growth would be needed given that inflation remains too low and unemployment too high.

Federal Reserve Chairman Ben Bernanke said additional monetary stimulus may be warranted, as noted above, because inflation is too low and unemployment is too high. "There would appear—all else being equal—to be a case for further action," Bernanke said Friday at a Boston Fed conference. He said the central bank could expand asset purchases or change the language in its statement, while saying "nonconventional policies have costs and limitations that must be taken into account in judging whether and how aggressively they should be used."

PIMCO, which runs the world's biggest bond fund, said it sold Treasuries on expectations a second round of debt purchases (quantitative easing-QE2) by the Federal Reserve will have limited impact. "Even if the QE is large and rates decline further, in our view we're approaching the end of the bond market rally," Douglas Hodge, Chief Operating Officer, said in an interview at the World Knowledge Forum in Seoul last Thursday.

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THIS WEEK'S CALENDAR

E.D.T.	Amount	Ratings	Issuer	State	Structure	
Monday, October 18						
11:15AM	6,950M	UR/UR	Newport School District	PA	2012-2032	BQ
Tuesday, October 19						
10:30AM	5,500M	NR/A+	Campbell Co BABs	TN	2012-2030	
10:30AM	18,035M	Aa1/AA+	Hillsborough Co - REVS	FL	2013-2019	
11:00AM	7,900M	UR/UR	T/O Auburn	ME	2011-2020	BQ
11:00AM	24,000M	UR/UR	Franklin Co	NC	2012-2030	BQ
11:00AM	110,265M	Aa1/AA+	Hillsborough Co - Rev - BABs	FL	2020-2037	
11:00AM	38,070M	A1/NR	Jacksonville Beach - Rev	FL	2011-2020	
11:15AM	21,700M	Aa1/AA+	Hillsborough Co - Rev - RZEDs	FL	2038-2040	
11:15AM	6,980M	UR/UR	West Reading Boro	PA	2011-2032	BQ
11:30AM	13,190M	UR/UR	Dorcester Co Sch Dist #2	SC	2011-2018	
Wednesday, October 20						
11:00AM	111,505M	Aa2/NR	Suffolk Co	NY	2011-2029	
11:00AM	280,400M	Aa2/NR	Tri Bridge/Tunnel - BABs	NY	2021-2040	
11:00AM	66,560M	Aa2/NR	Tri Bridge/Tunnel Auth - T/E	NY	2011-2020	
11:00AM	2,900M	NR/AA	Lawnside Borough Sch Dist	NJ	2011-2027	BQ
11:00AM	1,330M	UR/UR	T/O Pembroke	MA	2012-2021	BQ
11:00AM	1,350M	UR/UR	T/O Walpole	MA	2011-2020	BQ
11:00AM	2,771M	UR/UR	T/O Weston	MA	2012-2021	BQ
Thursday, October 21						
10:30AM	175,355M	Aaa/AAA	S/O Delaware - TXBL BABs & QSABS	DE	2019-2030	
10:45AM	3,230M	NR/UR	Union School District	PA	2011-2024	BQ
11:00AM	14,815M	Aa1/NR	Carroll Co Comm	MD	2010-2017	
11;00AM	30,050M	UR/UR	Somerset Co CREB - TAXABLE	NJ	2012-2026	
11:00AM	3,800M	UR/UR	Pearl River	NY	2011-2019	BQ
11:00AM	13,500M	UR/UR	C/O Rahway	NJ	2011-2030	BQ
11:00AM	126,335M	Aa2/NR	Univ of Mass Bldg	MA	2011-2020	
11:15AM	27,210M	UR/UR	Willingboro Twp BOE	NJ	2012-2036	BQ
11:30AM	21,500M	Aa1/NR	Carroll Co Comm	MD	2011-2030	
11:30AM	2,980M	UR/UR	V/O Dobbs Ferry	NY	2038-2040	BQ
11:30AM	438,255M	Aa2/NR	Univ Of Mass Bldg - BABs	MA	2021-2040	
11:30AM	8,000M	Aaa/NR	T/O West Hartford	CT	2011-2025	BQ
11:45AM	3,141M	NR/AA	Park Ridge Boro BOE	NJ	2011-2025	BQ
12:00PM	13,240M	UR/UR	C/O Milford	CT	2011-2030	

Click here for calendar updates.

MARKET UPDATE (CONT'D)

Most municipal analysts bristle at the claim that California will become the next Greece. Among the important differences is that California prepares to repay debts with its own revenues; Greece assumes it can repay its debts by borrowing more. A common risk in most financing markets is "rollover risk." When a borrower has a debt coming

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VISIBLE SUPPLY

30-Day Visible Supply

Negotiated:	$8.232B
Competitive:	$4.276B
Total:	$12.507B

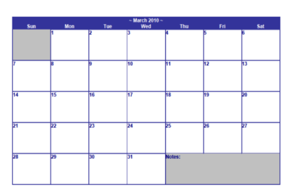
Week of Oct 18, 2010

Tax-Exempt:	$4.324B
Taxable/BABs:	$1.613B
Total:	$5.937B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters.

ECONOMIC CALENDAR



MARKET UPDATE (CONT'D)

due, it often needs to borrow again to pay off the existing loan, or "roll it over." Since municipal borrowers in the US generally plan to pay off debt steadily over time from taxes and other organic revenues rather than roll it over, this risk is far slighter in municipal investing than in most other markets.

After a two year struggle to launch Municipal and Infrastructure Assurance Corp. ("MIAC"), a muni-only bond guarantor, key investor Macquarie Group is exiting the bond insurance business or selling its stake. A source familiar with the start-up bond insurer said Macquarie has been unable to find fresh capital since co-sponsor Citadel LLC, the Chicago-based hedge fund, dropped out nearly a year ago.

Last week, the SEC approved an MSRB proposal to post credit ratings on its web site, EMMA.

Rockfleet sales and trading continues to receive positive feedback on the weekly newsletter and the daily secondary trading report, "The Navigator." The firm continues to deliver on its strategy of committing resources to the new issue market as the firm has underwritten as member or selling group member 285 competitive and negotiated transactions totaling $12.8 billion through mid-October since its operational start date in March 2010.♣

MUTUAL FUNDS AND MONEY MARKETS

Long-Term Mutual Fund Flows

Total estimated inflows to long-term mutual funds were $4.23 billion for the week ended Wednesday, October 6, the Investment Company Institute reported.

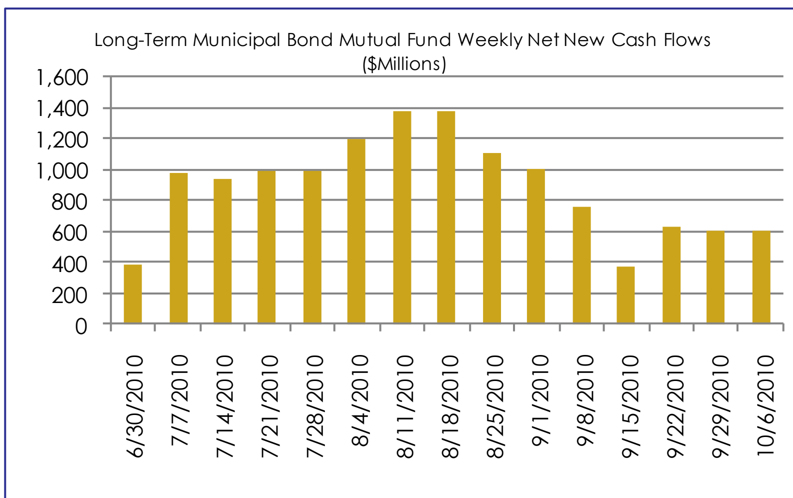
Municipal bond funds had estimated inflows of $605 million.

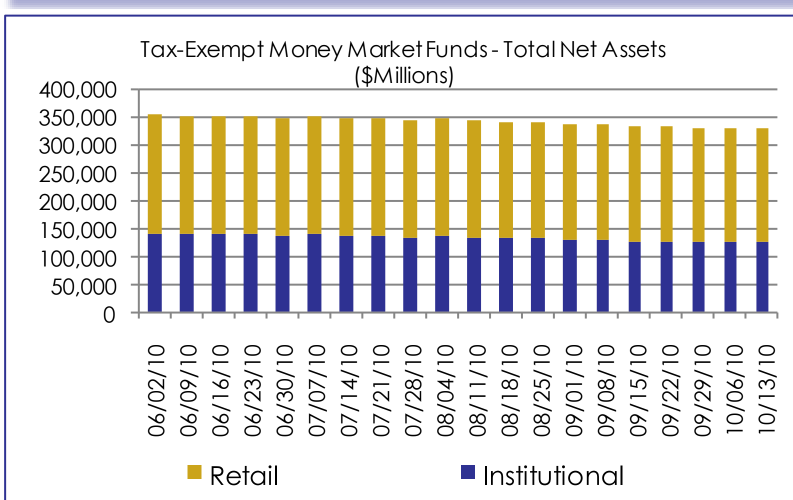
Money Market Mutual Fund Assets

Total money market mutual fund assets decreased by $5.81 billion to $2.799 trillion for the week ended Wednesday, October 13, the Investment Company Institute reported.

Tax-exempt funds decreased by $1.36 billion. Assets of retail money tax-exempt market funds decreased by $630 million to $203.34 billion. Institutional tax-exempt fund assets decreased by $730 million to $124.83 billion.♣

Source: Investment Company Institute.





FAMILY OFFICES TO BE REGULATED

Boutique registered investment advisers ("RIAs") may have an opportunity to break into the family office business, thanks to a provision of the Hedge Fund Transparency Act requiring the SEC to define "family office," according to Registered Rep magazine. On October 12, the SEC proposed to define a family office as any firm that:

- Provides investment advise only to family members, as defined by the rule; certain key employees; charities and trusts established by family members; and entities wholly-owned and controlled by family members;
- Is wholly-owned and controlled by family members; and,
- Does not hold itself out to the public as an investment advisor.

As of July 2011, family offices will no longer be exempt from registration due to having fewer than 15 clients. They have three options, according to John Duncan, a nationally recognized expert on family office legal issues:

- Register with the SEC as an RIA;
- Form a private trust company; or,
- Turn to an established RIA firm for investment advisory services.

Family Office Exchange has scheduled a workshop for November 10-11 in Chicago to discuss alternatives. The event is limited to wealthy individuals, executives of single-family offices, and qualified multi-family offices. ♣

RATING AGENCY REFORM (CONT'D)

function used to price ABSs. The problem was that the calculation never considered all the correlations among loans in the pool, nor a worst case scenario. ABS debt became the rotten apple that spoiled the ratings barrel.

Much commentary on the necessity to reform the credit rating agency business model cites the "clear" conflict of interest in agencies being paid by issuers. Others add that a "cartel" of a Big Three (Moody's Investors' Service, Standard & Poors and Fitch Ratings) creates a bottleneck in the system due to lack of competition. That is, the rating agencies became a narrow channel through which so-called "investment grade" securities entered the market and others were kept out, or sold at premium as a "businessman's risk."

Blame has been assigned either for lack of a response, e.g., maintaining a high rating on Enron until it collapsed, or too quick a response, e.g., downgrading sovereign debt of Greece, which some considered worsened the current situation in Europe. When the agencies began to lower their ratings on ABSs in late 2007 to 2008, the resulting reduction in value put pressure on the financial institutions holding that debt to maintain capital ratios, which in turn, accelerated the crisis.

There were shouts for action. In July 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") to reform the financial markets. One key area of focus of this legislation is credit rating agencies. The Securities and Exchange Commission ("SEC") issued a six month "no action letter" providing time for a transition during which more than sixty studies are to be completed under new legislation, resulting in possibly over 200 new

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UPCOMING EVENTS

International City/County Management Association's 96th Annual Conference
October 17 – 20, 2010
San Jose, CA

8th Annual New England Public Finance Conference
October 18, 2010
Boston, MA

Information Management Network's 6th Annual North East Public Employee Retirement Systems Forum (NEPERS)
October 18, 2010
Boston, MA

Milken Institute: California's Annual State of the State Conference 2010
October 19, 2010
Los Angeles, CA

IAWatch Form ADV, Part 2: Solid Advice to Satisfy the New Plain-English Requirements and Meet Your Filing Deadline
October 19, 2010 – 2:00 – 3:30 p.m. ET—Webinar

Bloomberg Altering the Financing Landscape for Financial Institutions
October 20, 2010
New York, NY

Smith's Research & Gradings State and Local Government Finance Conference
October 20 – 21, 2010
Chicago, IL

More events...

RATING AGENCY REFORM (CONT'D)

rules. Compliance is a growth industry.

Background

In 1909, John Moody began his business by appraising the risk of railroad bonds, a service for which investors paid. As a consequence of the Great Depression, new laws and regulations from state insurance commissions made rating agencies the de facto regulators, and perhaps only regulators, of state and municipal bonds, as only investment grade bonds could be bought and held by the insurance firms and later, banks. However, the agencies themselves were not regulated under the Securities and Exchange Act of 1934. It was assumed the market would self-regulate, and consequently, regulators outsourced their responsibilities to the rating agencies.

Until the 1970s, ratings agencies mainly earned money from bond buyers through the sale of reports and manuals. One speculation for the switch to charging issuers a fee is the ease with which materials could be reproduced and circulated due to the advent of the copy machine. In practice, the fee is part of the fee structure for bringing the bond to market and is taken from bond proceeds.

In 1975, the SEC established a process to qualify agencies as nationally recognized statistical rating organizations ("NRSROs"). Because the designation permitted other SEC-regulated bodies to use the ratings to satisfy regulatory requirements of their own, primarily net capital calculations for broker/dealers and permissible holdings for money market funds, it was sought-after recognition, providing the NRSRO with a competitive advantage.

Also in 1975, Congress established the Municipal Securities Rulemaking Board ("MSRB") as a self-regulating organization subject to supervision by the SEC. The probable motivation for these reforms was the crisis and subsequent bailout of New York City.

Market forces continued to self-regulate until 2006, when, in response to corporate scandals, President George W. Bush signed the Credit Rating Agency Reform Act ("CRARA") in an effort to improve the quality of ratings. The CRARA authorized the SEC exclusively to promulgate rules to govern any agency seeking NRSRO status. The anticipated result was an increase in transparency, accountability and competition. There are now ten recognized credit rating agencies, although the three primarily associated with municipal securities continue to be Moody's, Standard & Poors, and Fitch Ratings.

Conflict of Interest

Ratings are based on analysis of historic quantitative and qualitative information to arrive at a prediction of potential default risk relative to other entities in that sector. This combination of past events and future prognostication results in a present subjective judgment that can only be verified over time.

However, the judgment, or rating, is used to determine cost of capital and investment potential. This dual role is the crux of conflict: historical analysis and an opinion of future risk. Reliance on past trends is statistical analysis whereas market research is predictive. The agencies, in the case of municipal issuers, have historical trend data to support ratings and acted when circumstances changed. Market research, the kind done by sell side firms, was predictive and did not always account for credit quality. This market approach worked until the firms created new products and taught the agency analysts how to appraise them.

Historically, corporate and municipal ratings hold up over time. According to Moody's, the five year cumulative default rate for municipal debt of investment grade was 0.03% and 0.97% for corporate investment grade debt. Additionally, Moody's reports that in the period 1970 to 2009 there were only fifty four municipal defaults, with 78% of those in the health care or housing sector. It was with structured securities that the rating agencies failed. That failure was significant: $3.2 trillion in loans to fund the housing bubble. High ratings allowed those securities to be sold globally.

Recent Regulatory Reform

Dodd-Frank has been the most significant reform of the financial system since 1934. Among several components was the creation of an Office of Credit Ratings within the SEC to for oversight and enforcement of regulations regarding NRSROs.

Disclosure of rating agency policies, procedures and methodologies led to a discussion of how the system could "game" the agencies. In some cases it seemed apparent that certain banks or investment firms had schooled agency analysts in order to achieve ratings higher than they might otherwise have been assigned. No prior legislation regulated rating agency process and methodologies.

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RATING AGENCY REFORM (CONT'D)

Effective October 4th this year, the SEC revised Regulation FD (17 C.F.R. 243.100 (b)(2)(iii) to end exemption of credit rating agencies from standards applied to street analysts. Dodd-Frank rescinded Rule 436(g) and now NRSROs are exposed to the same liability as other experts, such as accountants, investment advisors or sell-side analysts.

The view is that a rating includes a forward looking basis for the rating grade. Fitch issued a disclaimer that "a rating does not address the risk of loss due to risks other than credit risk." The rescinded rule affects asset backed securities and corporate bonds; no mention was made of municipal bonds. Should the rating agencies treat municipals as they do other instruments as a safe practice, that means a rating may no longer be on the front cover of an official statement, nor used to promote the issue; written permission to use a rating will be required.

Two very different approaches recommended ways to reform the credit agencies. One, the Franken Amendment, addressed the issue of conflict of interest by having the SEC create a Rating Advisory Board to select one qualified NRSRO to rate an issue. This would have brought the government directly into the rating process, something Warren Buffett dismissed as "outlandish." The amendment passed the Senate by 64 to 35, but was discarded in the reconciliation bill. As part of the reconciliation for passage of Dodd-Frank, the Franken Amendment will be reconsidered in two years.

The LeMieux/Cantwell Amendment recommended the elimination of any reference to ratings from all financial regulations. By excluding ratings from the process entirely and eliminating statutory protections, the Amendment also resolves the issue of indemnification. Within one year, the SEC must evaluate and make recommendations to Congress regarding how credit ratings can be standardized and better utilized as a tool for evaluating general investment risk. This amendment also will be reconsidered in two years.

In order to deal with increased regulatory requirement and compliance costs, both Moody's and Standard & Poor's announced plans to increase rating fees. The barrier to entry was already high, given the market's preference for a firm's reputation, its reliability of ratings, and the need for an agency to have professional staff to perform analysis. Ironically, by increasing the cost of doing business the impact of new legislation may well be to confirm the dominance of the Big Three firms.

First Amendment Protection and Indemnification Requirements

Historically, rating agencies have maintained that they are like journalists — a rating is only an opinion, and therefore the methodology and content of a rating is not subject to government regulation.

In 2009, Judge Scheindlin rejected arguments that the rating agencies had protection under the First Amendment (Abu Dhabi Commercial Bank et alia v. Morgan Stanley & Co.). Failing to gain constitutional protection, Moody's Investors Service added a provision to require issuers, including those in the municipal sector, to indemnify the rating agency for legal costs arising from failure to conform to new financial regulatory laws. If the rating agency itself committed fraud, the issuer would not have liability for those actions.

Bond attorneys tend to doubt such a clause can be enforced. There are complications of state law governing

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UPCOMING EVENTS

ETF 360 Conference
October 21, 2010
New York, NY

2010 Society of Civil Engineers' Annual Conference
October 21 – 23, 2010
Las Vegas, NV

DASNY's 25th Annual Minority, Women & Small Business Enterprises Conference
October 22, 2010
Albany, NY

National Recreation and Park Association: 2010 Congress and Exposition
October 25 – 29, 2010
Minneapolis, MN

Texas Municipal League 98th Annual Conference and Exhibition
October 26 – 29, 2010
Corpus Christi, TX

The Financial Markets Association Legal & Legislative Issues Conference
October 27 – 28, 2010
Washington, DC

Regulatory Compliance Association 2010 Asset Management Thought Leadership Symposium
November 3, 2010
New York, NY

Texas Public Purchasing Association Fall Conference 2010
November 3 – 5, 2010
Tyler, TX

More events...

RATING AGENCY REFORM (CONT'D)

municipalities as well as the need for annual appropriations to cover costs.

Municipal Issues

Municipal issuers today face a hostile environment of economic recession and fearful credit markets still reeling from the collapse of the subprime mortgage market. Low interest rates may continue to move capital to other investments, including cash and gold. Reduced personal income, property, and sales tax collections, a declining housing market that reduces mortgage transfer tax receipts, and an increased demand for social services combine with municipal pension and other post employment benefit liabilities to create budget shortfalls. Those municipalities that used derivatives to hedge against interest rate now face costly current payments as well as a significant premium to terminate prior to maturation of the contract.

Reform also impacts municipal issuers. Municipal advisors now need to contend with registration which imposes a fiduciary obligation. They are now subject to section 15(b)(4) of the Exchange Act. One of the studies mandated under Dodd-Frank is a review of disclosure requirements made by municipal issuers, which must be implemented within two years. The cost of bond issuance has risen.

Given the anxiety surrounding recent sovereign debt conditions, the market will likely pay more attention to any perceived worsening condition in municipal bonds. The length of the recovery will be a determining factor in the degree of uncertainty in the market. In turn, this may affect issuance of municipal debt.

It is under this set of circumstances that downgrades or inaction by the credit agencies may be considered causal. Downgrades can prompt selling by investors or institutions that could ripple across the entire municipal market, affecting other issuers.

Conclusion

The situation for financial services has irrevocably changed. Rating agencies will be held accountable for their opinions, and may increase their fees to support compliance staff added to handle Dodd-Frank regulations. The Franken and LeMieux/Cantwell Amendments will be reconsidered in two years. The way of doing business as an opinion based on past trends may be replaced by a model more market-focused with pre-emptive actions. Given the higher threshold to conduct business, the smaller agencies may combine or disappear, especially if the uncertainty over liability is unresolved.

Many rule making actions are required within one year by the SEC regarding NRSROs. Enforcement by this, and subsequent Administrations, will be evidenced by the selection of SEC appointees for enforcement. ♣

Louise Gantrell is a contributor to Muni Market Update. The opinions expressed are her own.

MARKETTAKE™—A RATING AGENCY ALTERNATIVE

The turmoil and uncertainty that plagues the rating agency landscape provides an opening for alternative models to the traditional credit rating process.

MarketTake™, a start-up enterprise, utilizes a web-based survey format to generate market-driven assessments of municipal credit. By aggregating the survey results on featured municipal bonds, the MarketTake™ Score provides a bottom-up indicator of credit as a counter to the top-down approach of the rating agencies. MarketTake Scores™ are continuously updated making them dynamic and fast-forward yardsticks of market sentiment.

MarketTake's goal is to create a credit-networking community where interested parties—issuers, investors, advisers, securities dealers and others—share views, not only on market trends but on specific bond issues.

MarketTake™ provides municipal bond participants with access to credit reports, analyses of MarketTake Scores™, dedicated bond discussions as well as a forum on general topics of interest to the fixed income markets.

Anyone interested in municipal bonds and public finance issues is encouraged to go to markettake.com, register (only the first time), vote your credit opinion on the featured bonds, and participate in the bond discussion.

Make your opinion count! ♣

ROCKFLEET financial services

515 Madison Avenue, 27th Floor
New York, NY 10022
Phone: 212-888-1301
Fax: 212-572-9814
Email: sales@rockfleetfinancial.com
www.rockfleetfinancial.com

MELEGA JOINS ROCKFLEET SALES

Peter Melega joined Rockfleet in municipal institutional sales this week in the firm's New York City office.

Peter brings twenty-seven years of municipal securities experience to the firm. Previously the manager of the Wachovia (formerly Prudential) short-term trading and underwriting desk, Peter's credentials also include increasing responsibilities in the municipal securities departments of PaineWebber, First Albany, Chemical Securities and Kidder Peabody. ♣