

## The Final Municipal Advisor Rule: Navigating the Minefield

***While the final rule narrows the scope and reach of the proposed rule, market participants that interact with municipal entities will still need to tread carefully through the complex regulatory framework.***

### What is the “municipal advisor” rule?

On January 13, 2014, the final rules (the Final Rule)<sup>1</sup> for the registration of municipal advisors with the Securities and Exchange Commission (SEC) become effective, putting in place a permanent registration regime established pursuant to Section 975 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and Section 15B of the Securities Exchange Act of 1934 (the Exchange Act). As the SEC has noted, the Final Rule is significantly narrower than the original proposal,<sup>2</sup> which was alarmingly expansive (see our *Alert*, “[The Municipal Advisor Minefield](#)”).<sup>3</sup> But “narrower” does not necessarily mean “narrow,” and the SEC has continued to err on the side of inclusiveness. The result is a complicated package of rules and interpretations that will create compliance challenges for many market participants that operate outside the classic model of a municipal advisor.

Entities whose activities satisfy the definition of a municipal advisor and who cannot avail themselves of any exemptions must register with the SEC and the Municipal Securities Rulemaking Board (MSRB) and thus become subject to extensive regulatory obligations, including disclosure, record keeping, compliance with pay-to-play rules (similar to those applicable to municipal dealers and investment advisers) and, most notably, a fiduciary duty.

The Final Rule will replace the proposed rule and temporary registration regime that has been in place since 2010.

### Who is a municipal advisor?

A municipal advisor is a person who (1) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such financial products or issues, or (2) undertakes a solicitation of a municipal entity.<sup>4</sup> “Municipal entities” include municipal securities issuers, and other state and local subdivisions and agencies, and “obligated persons” include conduit borrowers who are committed to support the payment obligations on municipal securities. As discussed below, the Final Rule further defines certain key terms within this definition and provides certain exclusions and exemptions that have effectively narrowed the application of this otherwise very broad definition.

## Advice

New Rule 15Ba1-1(d)(1)(ii) provides that “advice” includes a recommendation that is particularized to the specific needs, objectives or circumstances of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including with respect to the structure, timing, terms and other similar matters concerning such financial products or issues, based on all the facts and circumstances. The SEC’s approach as to what constitutes a “recommendation” for purposes of the Final Rule is consistent with FINRA’s rules in this regard — that is, the more individually tailored the communication, the greater the likelihood that the communication may be viewed as a recommendation, especially where the information provided is targeted to a particular audience, taking into account the content, context and manner in which the information is presented.<sup>5</sup>

Advice expressly excludes the provision of “general” information regarding municipal financial products or the issuance of municipal securities. The SEC has provided guidance that general information includes:

- Factual information without subjective assumptions, opinions or views
- Information that is widely disseminated for use by the public or market participants other than municipal entities or obligated persons
- Educational materials (e.g., explanatory or instructional information which does not include performance figures or a recommendation to buy or sell a particular product or strategy)<sup>6</sup>

The SEC has also clarified that there is no exemption for one-time or incidental advice.<sup>7</sup>

## Advice to municipal “plans”

Under the proposed rule, the SEC interpreted “municipal financial products” to include pools of funds held by municipalities without regard to the qualifier in the statute that a plan or program relate specifically to the “investment of proceeds of municipal securities”.<sup>8</sup> To arrive at this interpretation requires parsing through Exchange Act Section 15B(e)(5), which defines “municipal financial product” to mean municipal derivatives, guaranteed investment contracts and *investment strategies*, and Section 15B(e)(3), which defines investment strategies to include “*plans* or programs for the investment of the proceeds of municipal securities.” As a result, the proposed rule captured advice to state pension plans and other municipal investment pools. Thus, given the broad reading of “advice,” everything from assisting state pension funds with their secondary market trading activities to the opening of a bank account for a municipal entity appeared to be captured.<sup>9</sup>

However, in the Final Rule, the SEC has clarified that the term “investment strategies” should be read to be limited to only those pools of funds for the “investment of the proceeds of municipal securities” and “the recommendation of and brokerage of municipal escrow investments,” which substantially narrows the application of the advice prong of the Final Rule. In other words, a market participant should only fall within the ambit of this portion of the rule if the participant advises on specific categories of activities, such as, (i) how to invest proceeds of municipal securities, (ii) how to invest municipal escrow funds or (iii) activities related to municipal derivatives.<sup>10</sup>

## Soliciting

Under the second prong of the definition of a municipal advisor, a person who solicits a municipal entity or obligated person on behalf of certain specified persons must be registered as a municipal advisor or otherwise exempt.<sup>11</sup> Simply put, a “solicitation” occurs when a person solicits a municipal entity to obtain or retain an engagement in connection with municipal financial products, the issuance of municipal

securities or investment advisory services on behalf of another entity.<sup>12</sup> In other words, this prong applies only to solicitations on behalf of third parties. As such, a broker-dealer or investment adviser soliciting a municipal entity on its own behalf with regard to such services or otherwise would not fall within the definition as a result of such solicitation.<sup>13</sup>

In addition, the SEC clarified as part of the Final Rule that placement agents for private funds will not fall within the definition of municipal advisor for soliciting a municipal entity's investment in a fund. The rationale is that the placement agent is not soliciting on behalf of a third party to obtain or retain an engagement to provide advice or services to a municipal entity. In such case, while the placement agent may be soliciting an investment from the municipal entity on behalf of an investment adviser, there is no engagement the adviser is seeking with respect to the municipal entity. Rather, the adviser is engaged by the fund and the municipal entity is merely sought as an investor in the fund.<sup>14</sup> The SEC also clarified that persons assisting a municipal entity or obligated person in reviewing requests for proposals to select a broker-dealer, investment adviser or financial advisor would not be captured under this portion of the Final Rule.<sup>15</sup>

## **Who is exempt from falling under the municipal advisor regime?**

As mentioned above, the Final Rule includes exemptions and exclusions from the definition of municipal advisor and the mandatory registration requirements, based on the activities (rather than the identity or type) of market participants. We summarize certain key exclusions and exemptions below.

### **Underwriters**

The "underwriter exclusion" in Exchange Act Section 15B(e)(4)(C), as interpreted by the SEC under the Final Rule, provides that the term municipal advisor does not include a broker, dealer or municipal securities dealer serving as an underwriter of a *particular issuance* of municipal securities, to the extent that these enumerated parties are engaged in activities that are *within the scope* of an underwriting engagement between them and the municipal entity or an obligated person.<sup>16</sup> A broker, dealer or municipal securities dealer wanting to avail itself of the underwriter exclusion would only be able to advise on the structure, timing, terms and other similar matters in the context of a specific issuance, where such underwriter has a direct relationship to a particular transaction. Other activities within the scope of this exclusion include preparation of rating strategies, the preparation of presentations related to the offering, assistance with the planning and execution of road shows, advice regarding retail order periods and institutional marketing.<sup>17</sup>

Importantly, general advice by an underwriter engaged by a municipal entity to serve as a member of an underwriting pool would not satisfy the parameters of the underwriter exclusion, as the particularity requirement likely would not be satisfied. Advice provided on refunding escrows or municipal derivatives, even if related to the particular issuance, would generally likewise fall outside the scope of the underwriter exclusion. In addition, certain specified activities fall outside the scope of the exclusion, including advice on whether an issuance should be a negotiated sale or competitive sale and the preparation of feasibility analyses as well as budget planning and analyses.<sup>18</sup>

Notably, underwriters that provide advice in response to a request for proposals on a proposed municipal issuance (which may or may not materialize) are not required to register as a municipal advisor. However, advice regarding the terms of an RFP would trigger municipal advisor registration.

### **Banks**

In response to industry comments, the Final Rule created a tailored exemption for banks ensuring that simply opening a checking account for a municipal entity would not result in the bank having to register as

a municipal advisor, as was the concern under the proposed rule.<sup>19</sup> Any bank<sup>20</sup> that only provides advice with respect to the following is exempt from the municipal advisor requirements under the Final Rule:

- Any investments that are held in a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank
- Any extension of credit by a bank to a municipal entity or obligated person, including the issuance of a letter of credit, the making of a direct loan, or the purchase of a municipal security by the bank for its own account
- Any funds held in a sweep account; or
- Any investment made by a bank acting in the capacity of an indenture trustee or similar capacity (e.g. a bond indenture trustee, paying agent, or municipal escrow agent)<sup>21</sup>

In other words, only banks that engage in municipal advisory activities, *i.e.* banks that act as advisors to municipal entities in the structuring of municipal issuance of securities and act as advisors with respect to municipal derivatives, will be required to comply with the requirements of the Final Rule.

## **Registered swap dealers and registered commodity trading advisors**

### **Registered swap dealers**

Swap dealers that are registered with the Commodity Futures Trading Commission (CFTC) and their associated persons who recommend a municipal derivative or a trading strategy that involves a municipal derivative, do not have to register as municipal advisors provided that they are not *acting as an advisor* to the municipal entity or obligated person.<sup>22</sup> For purposes of determining whether the swap dealer is “acting as an advisor,” the SEC has looked to the CFTC’s external business conduct rules for swap dealers, which allow swap dealers to transact with “special entities” as defined under the Commodity Exchange Act<sup>23</sup> without being subject to the heightened requirements when “acting as an advisor” as set forth in the CEA, if three conditions are met:

- The swap dealer does not express an opinion as to whether the special entity should enter into the swap.
- The special entity represents in writing that it is not relying on advice from the swap dealer and that it has an independent advisor.
- The swap dealer discloses in writing that it is not undertaking to act in the special entity’s best interests.<sup>24</sup>

Thus, under the SEC rules, a swap dealer that satisfies these conditions when transacting with a municipal entity or obligated person is not acting as a municipal advisor — regardless of whether such municipal entity or obligated person is otherwise a special entity.<sup>25</sup>

Although helpful, the exclusion provided by the SEC for swap dealers creates a number of implementation challenges and leaves significant gaps.

First, as with the other SEC exemptions from the municipal advisor rules, it applies only to *registered* swap dealers. Entities that are relying on the *de minimis* exception from swap dealer registration or the

exemption for insured depository institutions that enter into swaps in connection with the origination of a loan will thus not benefit from this exclusion.

Second, the definitions of “municipal entity” and “obligated person” include entities that are not special entities, which means that the diligence swap dealers have done using industry protocols and other documentation to identify their special entity customers will not be sufficient to pick up all entities to which the Final Rule applies.

Third, the definition of “municipal derivative” is not co-extensive with the definition of “swap.” The term “municipal derivative,” for instance, includes a “security-based swap,” which registered swap dealers may not have made subject to their policies and procedures, and for which the SEC has declined to provide a comparable exclusion for security-based swap dealers. Conversely, the term “municipal derivative” does not appear to include foreign exchange swaps and foreign exchange forwards, but these may still be picked up under the “investment strategies” prong of the Final Rule.

Finally, as with the other exclusions, the swap dealer exclusion is activity-based rather than status-based. Thus, swap dealers that engage in other municipal advisory activities such as providing advice on the issuance of municipal securities or the investment of the proceeds of municipal securities or municipal escrow investments would not be able to avail themselves of the exclusion.

### **Registered commodity trading advisors**

Commodity trading advisors (CTAs) and their associated persons that are registered with the CFTC are not required to register as municipal advisors provided that they only provide advice in relation to swaps.<sup>26</sup> As in the case of registered swap dealers, this exemption helps ensure that the Final Rule does not create duplicative regulation. As with the exclusion for swap dealers, the CTA exclusion does not appear to extend to products such as exempt foreign exchange swaps and forwards. As noted previously, it also does not extend to entities that are exempt from registration as CTAs or relying on CFTC no-action relief. Although the SEC has provided some examples of circumstances when registration is clearly warranted, the SEC has not provided adequate guidance as to what advice “*related to*” swaps actually means. Thus, CTAs will likely need to monitor all activities conducted with a municipal entity or obligated person to ensure those activities fall within the scope of the exemption and do not trigger a registration obligation.

### **Federally registered investment advisers**

Exchange Act Section 15B(e)(4)(C) exempts from the definition of municipal advisor any investment adviser registered under the Investment Advisers Act of 1940 (the Advisers Act), or persons associated with such investment advisers who are providing investment advice pursuant to an advisory agreement within the scope of the Advisers Act. However, the Final Rule clarifies that in this context, advice concerning whether and how to issue municipal securities; advice concerning the structure, timing, and terms of an issuance of municipal securities and other similar matters; advice concerning municipal derivatives; or advice related to the solicitation of a municipal entity or obligated person is not exempted. If an investment adviser engages in providing this type of advice, the adviser must register as a municipal adviser absent another applicable exemption or exclusion.<sup>27</sup>

In addition, it should be noted that those controlled by or under common control with a registered investment adviser are exempt for purposes of the solicitation prong of the Final Rule. However, affiliates are not exempted for purposes of the advice prong, and must register as municipal advisors unless they can avail themselves of a separate exemption or exclusion.<sup>28</sup>

There are no specific exemptions for exempt reporting advisers or state-registered investment advisers.<sup>29</sup>

### **Public officials and employees of municipal entities and obligated persons**

The following categories of public officials are exempt from the definition of municipal advisor under the Final Rule:

- Any person serving as a member of a governing body, its advisory boards and committees, and persons acting in a similar official capacity with respect to, or as an official of, a municipal entity or obligated person to the extent that such person is acting within the scope of the person's official capacity
- Any employee of a municipal entity to the extent that such person is acting within the scope of the person's employment; and
- Any board member, officer or employee of an obligated person to the extent that such person is acting within the scope of the person's employment or capacity<sup>30</sup>

### **Independent advisor representation**

The exemption in the Final Rule that may prove most useful for many market participants is the provision that anyone may be exempt from the municipal advisor definition to the extent that the municipal entity or obligated person is represented by an independent registered municipal advisor. For the exemption to apply, the independent advisor must be providing advice with respect to the same matters as the person seeking the exemption and the independent advisor must not have been associated with such person for the past two years. In addition, the parties must exchange writings that essentially acknowledge the application of the exemption.<sup>31</sup>

### **So, what is the scope of this fiduciary duty?**

The Final Rule enables the MSRB to proceed with promulgating its municipal advisor rules and regulations, including with respect to the parameters of the fiduciary duty — and to date such rule has yet to be proposed. The scope of the application of this duty, however, is specified in the statute. Exchange Act Section 15B(c)(1) provides that, “A municipal advisor and *any person associated with such municipal advisor* [emphasis added] shall be deemed to have a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor, and no municipal advisor may engage in any act.... which is not consistent with a municipal advisor's fiduciary duty....” Section 15B(e)(7) defines “any person associated with a municipal advisor” as including “any person directly or indirectly controlling, controlled by, or under common control with such municipal advisor.”

Accordingly, the statute applies the fiduciary duty to affiliated entities of the municipal advisor. Of course, this could present significant challenges for large financial institutions that have a business line that requires registration as a municipal advisor. If not limited by rulemaking, this could lead to firms choosing to exit from businesses that require such registration.<sup>32</sup>

### **When do we need to worry about the new rules?**

The Final Rule for the registration of municipal advisors with the SEC will become effective on January 13, 2014, and all municipal advisors must register under the new permanent municipal advisor registration system as follows:<sup>33</sup>

- A firm that is registered under the temporary regime prior to January 13, 2014 must register under the permanent regime in the applicable time period indicated below

<b>Temporary Registration Number</b>	<b>Permanent Registration Period</b>
866-00001-00 through 866-00400-00	July 1, 2014 through July 31, 2014
866-00401-00 through 866-00800-00	August 1, 2014 through August 31, 2014
866-00801-00 through 866-01200-00	September 1, 2014 through September 30, 2014
866-01201-00 and higher	October 1, 2014 through October 31, 2014

- A firm that is required to register as a municipal advisor on or after January 13, 2014 but before the applicable permanent registration period, must first register under the temporary regime as a municipal advisor and then must register under the permanent regime within the applicable permanent registration period
- Temporary registrations that are not replaced by a permanent registration will expire 45 days after the end of the applicable permanent registration period
- A firm that enters into the municipal advisory business on or after October 1, 2014 must file a complete application for registration under the permanent regime and be registered with the SEC before engaging in municipal advisory activities

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#### Endnotes

- <sup>1</sup> New Rules 15Ba1-1 through 15Ba1-8, new Rule 15Bc4-1.
- <sup>2</sup> On December 20, 2010, the SEC voted to propose a rule that required certain market participants who were unregulated prior to the Dodd-Frank Act to register and become subject to the municipal advisor regulatory regime when they acted in the capacity of a "municipal advisor." The proposed rule supplanted a temporary rule (on the subject of registration by municipal advisors) adopted by the SEC in September 2010. See Exchange Act Release No. 63576, 76 Fed. Reg. 824 (January 6, 2011).
- <sup>3</sup> Final Rule, 78 Fed. Reg. 67468, 67470.
- <sup>4</sup> Exchange Act Section 15B(e)(4)(A).
- <sup>5</sup> Final Rule, 78 Fed. Reg. 67468, 67480.
- <sup>6</sup> Final Rule, 78 Fed. Reg. 67468, 67479-80.
- <sup>7</sup> Final Rule, 78 Fed. Reg. 67468, 67493, 67516 and 67523.
- <sup>8</sup> Exchange Act Section 15B(e)(3).
- <sup>9</sup> See comment letters submitted by the Securities Industry and Financial Markets Association (SIFMA), dated February 22, 2011 and the National Association of Bond Lawyers (NABL), dated February 25, 2011.
- <sup>10</sup> "Specifically, Rule 15Ba1-1(d)(3)(vii), as adopted, exempts from the definition of municipal advisor any person that provides advice to a municipal entity or obligated person with respect to municipal financial products to the extent that such person provides advice with respect to investment strategies that are not plans or programs for the investment of the proceeds of municipal securities or the recommendation of and brokerage of municipal escrow investments." Final Rule, 78 Fed. Reg.

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67468, 67492. The term “proceeds of municipal securities”, in turn, is largely based on how that term is defined under the Internal Revenue Code. Final Rule, 78 Fed. Reg. 67468, 67492-3.

<sup>11</sup> Exchange Act Section 15B(e)(4)(A).

<sup>12</sup> “[T]he term ‘solicitation of a municipal entity or obligated person’ means a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser (as defined in section 202 of the Investment Advisers Act of 1940) that does not control, is not controlled by, or is not under common control with the person undertaking such solicitation for the purpose of obtaining or retaining an engagement by a municipal entity or obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.” Exchange Act Section 15B(e)(9).

<sup>13</sup> Final Rule, 78 Fed. Reg. 67468, 67499.

<sup>14</sup> Final Rule, 78 Fed. Reg. 67468, 67502.

<sup>15</sup> Final Rule, 78 Fed. Reg. 67468, 67499-500.

<sup>16</sup> Final Rule, 78 Fed. Reg. 67468, 67511.

<sup>17</sup> Final Rule, 78 Fed. Reg. 67468, 67513.

<sup>18</sup> Final Rule, 78 Fed. Reg. 67468, 67513-4.

<sup>19</sup> Comment letter submitted by the American Bankers Association (ABA), dated October 13, 2010.

<sup>20</sup> As defined in section 3(a)(6) of the Bank Holding Company Act of 1956.

<sup>21</sup> Rule 15Ba1-1(d)(3)(iii).

<sup>22</sup> Rule 15Ba1-1(d)(3)(v)(A).

<sup>23</sup> Commodity Exchange Act Section 4s(h)(2)(C).

<sup>24</sup> Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734 (February 17, 2012).

<sup>25</sup> Final Rule, 78 Fed. Reg. 67468, 67524.

<sup>26</sup> As defined in Commodity Exchange Act Section 1a(47) and Exchange Act Section 3(a)(69).

<sup>27</sup> Final Rule, 78 Fed. Reg. 67468, 67519.

<sup>28</sup> Final Rule, 78 Fed. Reg. 67468, 67520.

<sup>29</sup> Final Rule, 78 Fed. Reg. 67468, 67521.

<sup>30</sup> Rule 15Ba1-1(d)(3)(ii).

<sup>31</sup> Rule 15Ba1-1(d)(3)(vi).

<sup>32</sup> SIFMA letter dated April 11, 2011 to the MSRB regarding the fiduciary duty of municipal advisors and the application of MSRB Rule G-17 to municipal advisors.

<sup>33</sup> Final Rule, 78 Fed. Reg. 67468, 67581-3. The SEC extended the expiration date of the temporary registration rules to December 31, 2014 in order to allow municipal advisors to continue to remain temporarily registered during the staggered compliance period. Exchange Act Release No. 70468, 78 Fed. Reg. 59814 (September 30, 2013).