HAWKINS ADVISORY

SEC APPROVES MUNICIPAL ADVISOR RULES

On September 18, 2013, the Securities and Exchange Commission (the "SEC") unanimously approved final rules (the "Rules") governing the definition, registration, and regulation of municipal advisors.[1] In addition, the Rules provide guidance and clarification on several matters that had arisen because of provisions in the proposed rules.[2] Furthermore, the Rules provide exemptions from the definition of "municipal advisor" which, in some cases, go beyond the exclusions expressly provided for in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

This Hawkins Advisory describes the Rules, the corresponding statutory provisions, and the related rules of the Municipal Securities Rulemaking Board (the "MSRB"). The Rules will become effective 60 days after their publication in the Federal Register.

Municipal Advisor Provisions in the Dodd-Frank Act

Section 975 of the Dodd-Frank Act amended Section 15B of the Securities Exchange Act of 1934 (as amended, the "Exchange Act"), effective October 1, 2010, to, among other things: (i) require municipal advisors to register with the SEC; (ii) establish a fiduciary duty between a municipal advisor and a municipal entity for which it is acting as a municipal advisor;[3] and (iii) subject municipal advisors to an additional specific anti-fraud provision.[4]

Section 975 of the Dodd-Frank Act defines the term "municipal advisor" to mean "a person (who is not a municipal entity[5] or an employee of a municipal entity) that (i) provides advice to or on behalf of a municipal entity or obligated person[6] with respect to municipal financial products ["municipal derivatives," "guaranteed investment contracts" including forward supply contracts, or "investment strategies"][7] 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 (ii) undertakes a solicitation of a municipal entity."[8] Section 975 further provides, however, that the term "municipal advisor" expressly excludes, among others: (i) "a broker, dealer, or municipal securities dealer serving as an underwriter;" (ii) "any investment adviser registered under the Investment Advisers Act of 1940;" and (iii) "attorneys offering legal advice or providing services that are of a traditional legal nature." On the other hand, Section 975 expressly includes both "placement agents" and "swap advisors."

SEC Rulemaking Authority and Purpose

Notwithstanding that Section 975 provides a definition of "municipal advisor," as well as express inclusions and exclusions from such definition, the Rules serve several key purposes, including: (i) providing definitions of statutory terms that are not defined in the Exchange Act; (ii) clarifying definitions of terms that are defined in the Exchange Act; and (iii) providing exemptive relief beyond that expressly provided by the language of Section 975. The authority for the SEC to grant

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1 SEC Rel. No. 34-70462 (Sept. 20, 2013) (the "Adopting Release"). The SEC had previously adopted "an interim final, temporary rule and form" regarding municipal advisors, and on December 20, 2010, had proposed new rules for comment. SEC Rel. No. 34-63576 (the "Proposing Release"). The new rules that are the subject of this Advisory replace in their entirety such interim final, temporary rule and proposed rules. However, Form MA-T, which has been in use as a temporary registration form until the final rules were adopted, may continue to be used until December 31, 2014. The new registration forms will require registrants to provide considerably more information than the current Form MA-T requires.

2 *Id.*

3 "A municipal advisor and any person associated with such municipal advisor 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, practice, or course of business which is not consistent with a municipal advisor's fiduciary duty or that is in contravention of any rule of the [Municipal Securities Rulemaking] Board." [Exchange Act § 15B(c)(1)] The fiduciary duty does not extend, however, from a municipal advisor to an obligated person that is not a municipal entity.

4 "No municipal advisor shall make use of the mails or any means or instrumentality of interstate commerce to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products, the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, in connection with which such municipal advisor engages in any fraudulent, deceptive, or manipulative act or practice." [Exchange Act § 15B(a)(5)]

5 "Municipal entity" means "any State, political subdivision of a State, or municipal corporate instrumentality of a State, including (A) any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities." [Exchange Act § 15B(e)(8)]

6 "Obligated person" means "any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund or account of such person, committed by contract or other arrangement to support the payment of all or a part of the obligations on the municipal securities to be sold in an offering of municipal securities." [Exchange Act § 15B(e)(10)] This definition tracks the definition of "obligated person" in SEC Rule 15c2-12.

7 17 CFR § 240.15Ba1-1(f); Exchange Act § 15B(e)(2) and 17 CFR § 240.15Ba1-1(a); and Exchange Act § 15B(e)(3) and 17 CFR § 240.15Ba1-1(b), respectively.

8 In the Rules, notwithstanding the text of the definition of municipal advisor enacted by Section 975 of the Dodd-Frank Act, the SEC interprets clause (ii) above to include solicitation of either a municipal entity or an obligated person.

exemptive relief is Section 15B(a)(4) of the Exchange Act, which provides that the SEC:

> by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt any . . . municipal advisor, or class of . . . municipal advisors from any provision of this section [15B] or the rules or regulations thereunder, if the Commission finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of this section.

The Rules and the accompanying Adopting Release address the following key issues:

- ***Advice*** – Although the key statutory provision states that "[i]t shall be unlawful for a municipal advisor to provide *advice*" to specified persons regarding specified matters, neither the statute nor the proposing rules defined this term. The Rules provide an "advice standard."

- ***Board member*** – The proposed rules provided that any unelected member of a board of a municipal or governmental entity, or of a board of an obligated person, such as a nonprofit university, hospital, or museum, is a "municipal advisor." Significantly, the Rules provide instead that any member of a board of a municipal or governmental entity, or of a board of an obligated person, whether or not elected, will *not* be a "municipal advisor" to the extent acting within the scope of his or her official capacity.

- ***Underwriter*** – The status of entities such as remarketing agents or "best-efforts" underwriters was unclear because of the express statutory inclusion of "placement agents" in, and the express statutory exclusion of an "underwriter" from, the definition of a "municipal advisor". The Adopting Release provides guidance on this matter and sets forth numerous examples of those activities that will be considered within the exclusion for an underwriter.

- ***Exemptive Relief*** – In light of the "municipal advisor-like" activities that are common as part of the spectrum of activities conducted by an underwriter, the SEC provided exemptive relief for an underwriter that would otherwise be considered a municipal advisor if the issuer is represented by an independent municipal financial advisor with respect to such activities.

- ***Individual / Firm*** – The Rules clarify that it is the firm, and not each individual with a firm, that is to register as a "municipal advisor."

- ***Banks*** – The Rules provide guidance regarding which banking activities may result in a bank being considered a "municipal advisor." Banks that are municipal advisors are accorded the same flexibility provided currently to banks as municipal securities dealers to register a "separately identifiable department or division" of such bank.

Summary of Key Provisions

Advice Standard. The SEC received numerous comments regarding what constitutes "advice," and concluded that it "does not . . . believe that the term 'advice' is susceptible to a bright-line definition . . . [and] that 'advice' can be construed broadly . . . [and] depends on all the relevant facts and circumstances." However, the Rules do provide a standard that "advice excludes, among other things, the provision of general information that does not involve a recommendation regarding 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)."

The Adopting Release further advises as follows:

> the more individually tailored the information to a specific municipal entity or obligated person or a targeted group of municipal entities or obligated persons that share common characteristics, such as school districts or hospitals, with respect to municipal financial products or the issuance of municipal securities, the more likely it will be a recommendation that constitutes advice under the municipal advisor definition.[9]

Board Members and Employees of Municipal Entities. Section 15B excludes from the definition of a "municipal advisor" anyone who is "an employee of a municipal entity." But the Dodd-Frank Act does not provide a definition of the term "employee." In the Proposing Release, the SEC proposed that employees would include: (i) elected members of the governing body of a municipal entity; and (ii) appointed members who are *ex officio* members by virtue of holding an elective office, but that this exclusion would not extend to appointed members (who are not elected *ex officio* members). This proposal generated significant comment.[10] In the Rules, the SEC provided the following exclusions from the definition of "municipal advisor":

- ***Public official*** – "Any person serving as a member of a governing body, an advisory board, or a committee of, or 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 such person's official capacity."

[9] Adopting Release, p.47.

[10] See, e.g., Hawkins Advisory, "Municipal Advisor Registration - Effect of Proposed Rules on Issuer and Obligor Boards" (Jan. 12, 2011).

- ***Employee*** – "Any employee of a municipal entity or obligated person to the extent that such person is acting within the scope of such person's employment."

Thus, any member of a board of a municipal entity and any employee of a municipal entity would not be considered a "municipal advisor" if acting within the scope of his or her official capacity. In addition, the exemption will also apply if a board member or employee of one municipal entity provides advice, within the scope of such position or employment, to another municipal entity or obligated person.[11]

Board Members and Employees of Obligated Persons. The term "municipal advisor" is defined in the Exchange Act to include a person who "provides advice to or on behalf of a municipal entity or *obligated person*."[12] However, the statute only provides an exemption for "an employee of a municipal entity" and does not extend an exemption to an employee of an obligated person. "Obligated person" is defined in Section 15B(e)(10) of the Exchange Act as follows:

> any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person, committed by contract or other arrangement to support the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities.

"Obligated person" includes 501(c)(3) entities, such as colleges, universities, health systems, museums, secondary schools, and other similar entities.

In the Proposing Release, the SEC requested comments on "whether employees of obligated persons should be excluded, to the extent they are providing advice to the obligated person, acting in its capacity as an obligated person, in connection with municipal financial products or the issuance of municipal securities." The SEC received comment letters from a wide range of borrower entities, including health systems, educational facilities, hospital districts, cultural facilities authorities, universities, colleges, and other non-profit entities. In response to such comments, the SEC determined to use its exemptive authority to extend the statutory "employee of a municipal entity" exclusion to obligated persons, and thus the Rules exempt board members, officers, and employees of obligated persons.[13]

Exclusion of Underwriters. Section 15B(e)(4)(C) of the Exchange Act excludes from the definition of "municipal advisor" a "broker, dealer, or municipal securities dealer serving as an underwriter." The Rules provide that such statutory exclusion applies only "to the extent that the broker, dealer, or municipal securities dealer engages in activities that are within the scope of an underwriting of such issuance of municipal securities." The SEC clarified in the Adopting Release that activities within such scope "would generally include advice with respect to the structure, timing, terms, and other similar matters concerning the issuance of municipal securities."

On the other hand, the SEC further advised that "the following advice would be outside the scope of an underwriting for purposes of this exclusion: (1) advice on investment strategies; (2) advice on municipal derivatives; and (3) advice otherwise identified by the Commission to be outside the scope of an underwriting."[14] With respect to clause (3), the SEC further identified 12 activities that "are not within the underwriter exclusion because the activities are either not specific to a particular issuance of municipal securities for which a broker, dealer or municipal securities dealer could be serving as an underwriter or the activities are not integral to fulfilling the role of an underwriter."[15] Among such 12 activities is advice as to whether an issuer should use a competitive or negotiated sale, advice on a bond election campaign, and advice that is "not specific to a particular issuance of municipal securities on which a person is serving as underwriter and that involves analysis or strategic services." Correspondingly, the SEC specified nine activities that are within the scope of the underwriting exclusion, including preparation of rating agency presentations and "road shows" and advice regarding retail order periods and institutional marketing.[16]

The Adopting Release also provided guidance as to what is meant by "serving as an underwriter" and advised that there "must be a relationship to a particular transaction." Thus, "a contractual engagement by a municipal entity of a broker-dealer to serve as underwriter on a specific planned transaction for the issuance of municipal securities" would establish the requisite relationship, but serving as a member of an underwriting pool would not. Importantly, providing advice with respect to "the timing of a sale of a related transaction on which it is not engaged" would not be within the underwriter exclusion unless "such advice is also related to the tranche or transaction on which the underwriter is engaged."

The Adopting Release advised that the underwriter exclusion is not dependent on whether the broker-dealer is acting in an agent or principal capacity:

> The Commission believes that any registered broker-dealer who participates in a particular issuance of municipal securities, whether the broker-dealer is acting as agent (such as in a best-efforts offering) or is acting as principal (such as in a firm commitment offering) would not have to register as a municipal advisor if facts and circumstances indicate that the registered broker-dealer is performing municipal advisory activities that otherwise would be considered within the scope of the underwriting of a particular issuance of municipal securities . . . .

[11] Adopting Release, p. 139.

[12] Section 15B(e)(4)(A)(i) of the Exchange Act. (emphasis added)

[13] 17 CFR § 240.15Ba1-1(d)(3)(ii).

[14] Adopting Release, text accompanying fn. 584.

[15] See text of Adopting Release accompanying fns. 611-614.

[16] See text of Adopting Release accompanying fn. 604.

In addition, whether an underwriter may be considered to also be acting as a municipal advisor should be considered in light of the new exemption for circumstances in which an issuer is "otherwise represented by an independent registered municipal advisor," as summarized below under the next caption.

Also, the Rules provide a general exemption from the definition of "municipal advisor" for brokers, dealers, and other professionals responding to RFP requests:

> Any person providing a response in writing or orally to a request for proposals or qualifications from a municipal entity or obligated person for services in connection with a municipal financial product or the issuance of municipal securities; provided, however, that such person does not receive separate direct or indirect compensation for advice provided as part of such response.[17]

Although the Rules and the Adopting Release provide much useful guidance, it is clear that many of the activities that broker-dealers routinely engage in with municipal issuers with whom they have long-standing relationships could subject the broker-dealer to municipal advisor registration (and the corresponding application of a fiduciary duty). For example, the Adopting Release notes:

> The Commission recognizes, however, that a municipal entity issuer may wish to request advice on an issuance of municipal securities from a broker-dealer serving as a member of its underwriting "pool" that does not yet have a specific assignment from a broker-dealer engaged on related transactions or tranches. In such circumstances, the broker-dealer could respond within the requirements of one of the other exemptions of general applicability.

With respect to "exemptions of general applicability," the Adopting Release notes the RFP exception (described above) and the participation of another municipal advisor (described below). On the other hand, absent one of such exemptions, advice offered to a municipal issuer by a broker-dealer that regularly underwrites such issuer's financings, even in response to the issuer's request for such advice, could subject such broker-dealer to the municipal advisor regulatory regime. In addition, broker-dealers submitting unsolicited ideas for refunding candidates, new products, and other similar ideas to municipal issuers with whom they do not have an underwriting relationship specific to a current transaction may result in such broker-dealers being considered municipal advisors in such contexts. The key in each instance is the SEC's position that "a broker-dealer . . . not engaged to underwrite any particular issuance . . . is not acting as an underwriter."

As described above, the Adopting Release provides that for the exclusion for underwriters to apply "there must be a relationship to a particular transaction." If a broker-dealer has not been engaged by the issuer as an underwriter for a particular transaction, then "advice" regarding "municipal financial products or the issuance of municipal securities" could result in the broker-dealer being characterized as a "municipal advisor." This may be the case regardless of whether the broker-dealer is providing unsolicited advice or is providing advice in response to a question from the issuer. In these instances, the broker-dealer should consider the availability of the following options:

- Draft any communication such that it is not providing "advice" within the meaning of Section 15B(e) because the communication is general in nature and is not "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"[18]
- Provide any information in response to a request for proposals or qualifications, for which there is an exemption
- Rely on the fact that the issuer is represented by an independent registered municipal advisor with respect to the same aspects of the municipal financial product or issuance of municipal securities, for which there is an exemption from the municipal advisor definition
- In those instances in which the broker-dealer is engaged by the issuer, rely on the underwriter exclusion in the statute

If a broker-dealer is considered to be a municipal advisor, and none of the available exemptions or exclusions are present, then in addition to the statutory requirements of registration and a fiduciary duty, and the application of the Rules, the broker-dealer as municipal advisor would also be subject to various MSRB rules, the key ones of which in this context are described below.

Exemption - Participation by other Municipal Advisor. The Rules provide an exemption that was not included in the proposed rules for any person, *even if engaging in municipal advisory activities*, if the issuer is represented by an "independent registered municipal advisor." The term "independent registered municipal advisor" is defined to mean "a municipal advisor registered pursuant to section 15B of the [Exchange] Act and the rules and regulations thereunder and that is not, and within at least the past two years was not, associated . . . with the person seeking to rely on this [exemption]."[19] The exemption provides:

[17] 17 CFR § 240.15Ba1-1(d)(3)(iv).

[18] Adopting Release, p. 46.

[19] 17 CFR § 240.15Ba1-1(d)(3)(vi)(A).

The Commission exempts the following persons from the definition of municipal advisor to the extent they are engaging in the specified activities:

. . . .

Any person engaging in municipal advisory activities in a circumstance in which a municipal entity or obligated person is otherwise represented by an independent registered municipal advisor with respect to the same aspects of a municipal financial product or an issuance of municipal securities, provided that the following [three] requirements are met:

(A) Independent registered municipal advisor. An independent registered municipal advisor is providing advice with respect to the same aspects of the municipal financial product or issuance of municipal securities. . . .

(B) Required representation. A person seeking to rely on [this exemption] receives from the municipal entity or obligated person a representation in writing that it is represented by, and will rely on the advice of, an independent registered municipal advisor, provided that the person receiving such representation has a reasonable basis for relying on the representation.

(C) Required disclosures. (1) With respect to a municipal entity, such person discloses in writing to the municipal entity that, by obtaining such representation from the municipal entity, such person is not a municipal advisor and is not subject to the fiduciary duty [otherwise applicable to municipal advisors] with respect to the municipal financial product or issuance of municipal securities

. . . .

(2) With respect to an obligated person, such person discloses in writing to the obligated person that, by obtaining such representation from the obligated person, such person is not a municipal advisor with respect to the municipal financial product or issuance of municipal securities.[20]

The Adopting Release cites an MSRB study that approximately 70% (by volume) of municipal debt issued in 2008 involved the participation of municipal advisors.[21] Accordingly, this new exemption could result in most municipal financings only requiring municipal advisor registration by the entity expressly engaged to be a municipal advisor.

Exemption for Natural Persons. The Rules provide an exemption from the municipal advisor registration requirement for a "natural person . . . if he or she: (a) Is an associated person of an advisor that is registered with the Commission [as a municipal advisor] . . . [and] (b) Engages in municipal advisory activities solely on behalf of a registered municipal advisor."

As the Adopting Release explains:

In practical terms, this exemption means that employees of municipal advisory firms who do not engage in municipal advisory activities independently of their firms (e.g., by engaging in municipal advisory activities on the side as a sole proprietor) will not be required to register as municipal advisors.

While the Commission is not requiring municipal advisor registration for these natural persons, the Commission is requiring municipal advisory firms to provide the Commission with information relating to these exempted natural persons.

Exemption for Banks. The Exchange Act expressly excludes banks[22] engaged in numerous bank activities from the definitions of either "broker" or "dealer."[23] In addition, the Exchange Act definition of "municipal securities dealer" provides that if a bank is engaged in municipal securities dealer activities through a "separately identifiable department or division," then "the department or division and not the bank itself shall be deemed to be the municipal securities dealer."[24]

The Dodd-Frank Act did not provide any exclusion for banks or bank activities from the definition of "municipal advisor." The Rules provide an exemption from the definition of "municipal advisor" for any bank

to the extent the bank provides advice with respect to the following:

(A) Any investments that are held in a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank;

(B) 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;

(C) Any funds held in a sweep account . . . ; or

(D) Any investment made by a bank acting in the capacity of an indenture trustee or similar capacity.

[20] 17 CFR § 240.15Ba1-1(d)(3)(vi).

[21] Adopting Release, fn. 35, which cites MSRB study, "UNREGULATED MUNICIPAL MARKET PARTICIPANTS A CASE FOR REFORM," (Apr. 2009). That study notes that "[a]ccording to data obtained by the MSRB, approximately 70% of the total volume of municipal debt (by par amount) issued in 2008 was issued with the assistance of financial advisors."

[22] "Banks" are defined in section 3(a)(6) of the Exchange Act.

[23] Sections 3(a)(4) and 3(a)(5) of the Exchange Act.

[24] Section 3(a)(30) of the Exchange Act.

Exclusion of Registered Investment Advisers. Section 15B excludes from the definition of "municipal advisor" any "investment adviser registered under the Investment Advisers Act of 1940." The Rules provide that such exclusion applies "to the extent that such registered investment adviser . . . is providing investment advice in such capacity." The Rules further provide that "investment advice does not include 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 a solicitation of a municipal entity or obligated person."

Exclusion of Attorneys. The Dodd-Frank Act excludes attorneys from the definition of "municipal advisor" if they are "offering legal advice or providing services that are of a traditional legal nature."[25] The Rules provide that such exclusion requires an attorney-client relationship, and further such exclusion does not apply if the attorney otherwise represents himself or herself as a financial advisor or financial expert. Such representation does not have to be expressly stated. The Adopting Release notes that "the Commission would consider an attorney to be representing himself or herself as a 'financial advisor' or 'financial expert' if the attorney provides advice that is primarily financial in nature." Some examples provided are advice regarding "the financial feasibility of a project" and "advice recommending a particular structure as being financially advantageous under prevailing market conditions."

The Adopting Release provided guidance regarding what the SEC views as "traditional legal" advice, including:

- "preparation and delivery of the official statement or other disclosure document that describes the material terms and provisions of the transaction"
- "advice and documentation with respect to post-closing policies and procedures that are necessary for compliance with federal and state law during the term of the municipal securities or municipal financial product"
- "legal advice and services in determining ongoing compliance of an issue of municipal securities with the Federal tax law requirement to 'rebate' excess arbitrage earnings"

The Adopting Release noted that the "Commission recognizes that legal advice and services of a traditional legal nature in the area of municipal finance inherently involves a financial advice component." Furthermore, although the exclusion requires there to be an attorney-client relationship, the Commission clarified that the exclusion would apply to advice an attorney provides in a working group meeting context:

> In addition, if another participant in the issuance or transaction, who is not a client of the attorney, receives and acts upon the legal advice the attorney provides to its client, the attorney will not have to register as a municipal advisor. In this situation, the attorney is still only advising its client, even if the advice affects the actions of other participants in the transaction. This approach addresses commenters' concerns that bond counsel and other attorneys routinely share their views with non-client parties in a municipal finance transaction in the context of working group discussions.[26]

Certain Definitions.

"*Municipal Entity*". The Rules define "municipal entity" to mean "any State, political subdivision of a State, or municipal corporate instrumentality of a State or of a political subdivision of a State." The final phrase "or of a political subdivision of a State" is a clarification, as such phrase is not in the definition of "municipal entity" in Section 15B(e)(8) of the Exchange Act.

The Adopting Release advises that the "Commission believes public employee retirement systems and public employee benefit plans or public pension plans (including participant-directed plans, 403(b), and 457 plans) fall within the statutory definition of a municipal entity."

"*Obligated Person*". The SEC concluded in the Adopting Release that "there is no reason to differentiate the definition of obligated person for purposes of municipal advisor registration from the definition of obligated person for purposes of Rule 15c2-12." The SEC modified the definition that had initially been proposed "to clarify that the definition of obligated person excludes persons whose financial information or operating data is not material to a municipal securities offering, without reference to any municipal bond insurance, letter of credit, liquidity facility, or other credit enhancement."

The definition in the Rules is as follows:

> Obligated person has the same meaning as in section 15B(e)(10) of the [Exchange] Act [which tracks Rule 15c2-12]; provided, however, that the term obligated person shall not include: (1) a person who provides municipal bond insurance, letters of credit, or other liquidity facilities; (2) a person whose financial information or operating data is not material to a municipal securities offering, without reference to any municipal bond insurance, letter of credit, liquidity facility, or other credit enhancement; or (3) the federal government.[27]

[25] Section 15B(e)(4)(C) of the Exchange Act.

[26] Adopting Release, text accompanying fn. 820.

[27] 17 CFR § 240.15Ba1-1(k).

"*Investment Strategies*". The SEC had initially proposed that the term "investment strategies" include "the investment of the proceeds of municipal securities and plans, programs, or pools of assets that invest any other funds held by, or on behalf of, a municipal entity." In the Adopting Release, the SEC noted that "[c]ommenters generally opposed the proposed interpretation . . . [as] too broad, because it covers any fund held by a municipal entity, regardless of its source."

In response, the SEC narrowed the definition to apply to "investments of proceeds of municipal securities and the recommendation of and brokerage of municipal escrow investments." In addition, the SEC adopted a definition of "proceeds of municipal securities," which was explained in the Adopting Release as follows:

> Therefore, for purposes of the application of the definition of investment strategies and in response to comments raised on this issue, the Commission is adopting Rule 15Ba1-1(m)(1), which defines "proceeds of municipal securities" as (i) monies derived by a municipal entity from the sale of municipal securities, (ii) investment income derived from the investment or reinvestment of such monies, (iii) any monies of a municipal entity or obligated person held in funds under legal documents for the municipal securities that are reasonably expected to be used as security or a source of payment for the payment of the debt service on the municipal securities, including reserves, sinking funds, and pledged funds created for such purpose, and (iv) the investment income derived from the investment or reinvestment of monies in such funds.

The Rules also provide an exception from the definition of proceeds of municipal securities for 529 savings plans. The SEC explained the rationale as follows:

> Although interests in 529 Savings Plans may be municipal fund securities, and therefore municipal securities, monies derived from a municipal security issued by an education trust established under Section 529(b) come from individuals making investments for the purposes of prepaying or accumulating savings for higher education costs, and do not come from municipal entities. Because these monies are derived from individuals primarily for the benefit of these individuals and not municipal entities, the Commission does not believe persons engaged in activities with respect to these monies are appropriately governed by [the municipal advisor] registration regime.

"*Municipal Derivatives*". The term "municipal derivatives" is not defined in Section 15B of the Exchange Act. The SEC initially proposed to define such term to include "swaps" and "security-based swaps" if "a municipal entity is a counterparty, or to which an obligated person, acting in its capacity as an obligated person, is a counterparty."

In response to comments received, the SEC in the Rules distinguishes the application of such definition to municipal entities and to obligated persons. The Adopting Release explains the distinction as follows:

> [W]ith respect to municipal entities, the Commission has determined not to qualify the definition of municipal derivatives as being limited to those entered into in connection with, or pledged as security or a source of payment for, existing or contemplated municipal securities . . . .
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> . . . .
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> [W]ith respect to obligated persons, the coverage of the registration requirement is limited to advice relating to derivatives entered into by an obligated person in its capacity as an obligated person with respect to municipal securities.

MSRB Rules

Overview

MSRB Registration of Municipal Advisors. Municipal advisors are required to register with both the SEC and the MSRB, with registration with the SEC being a condition to registering with the MSRB. Since October 1, 2010, municipal advisors have been required to register with the SEC, and were required to register with the MSRB by no later than December 31, 2010. These registration requirements must be completed prior to engaging in municipal securities and advisory activities.

Proposed MSRB Rules on Municipal Advisors. In connection with its rulemaking authority, the MSRB made several rule proposals in 2011 regarding municipal advisors that were submitted to the SEC for approval. In September 2011, the MSRB withdrew the municipal advisor rule proposals until such time as the SEC adopted a permanent definition of the term "municipal advisor." The MSRB is in the process of reexamining the proposed rules prior to resubmitting such proposals to the SEC. On September 26, 2013, the MSRB announced that as a matter of policy it would integrate economic analysis into its rulemaking procedures in order to "help the SEC meet its statutory obligations to consider whether its approval of an MSRB proposed rule will promote efficiency, competition and capital formation."[28]

Existing MSRB Rules on Municipal Advisors. In addition to the withdrawn rule proposals, there are other MSRB rules that currently apply to municipal advisors, a list of which is available on the MSRB web site.

Municipal Advisor Professional Qualifications. The MSRB is in the process of establishing minimum professional qualifications for municipal advisors as required by the Dodd-Frank Act. The MSRB has been gathering information from munici-

[28] MSRB's "Policy on the Use of Economic Analysis in MSRB Rulemaking."

pal advisors and other practitioners to develop a professional qualification examination to assess the competency of entry-level municipal advisors. The content outline will be filed with the SEC and provide the basis for examination preparation. After the outline is approved by the SEC, the MSRB will announce the effective date for the municipal advisor professional qualification exam.

MSRB Rules Key to Municipal Advisor Analysis

The three key MSRB rules that broker-dealers must consider in the municipal advisor context are as follows:

- Rule G-17, the fair dealing rule
- Rule G-23, regarding the activities of financial advisors, and
- Proposed Rule G-36, on the fiduciary duty of municipal advisors

MSRB Rule G-17. MSRB Rule G-17 provides as follows:

> In the conduct of municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

The MSRB has provided an interpretive notice,[29] implementation guidance,[30] and answers to frequently asked questions,[31] regarding Rule G-17 since the adoption of the Dodd-Frank Act. The MSRB has advised that Rule G-17's fair dealing principle requires the underwriter to disclose to the issuer that "unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests." Furthermore, an underwriter must disclose that the underwriting is "an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer." This disclosure must be made at the earliest stages of the underwriter-issuer relationship, as also required by the Rule G-23 interpretive notice.

MSRB Rule G-23. MSRB Rule G-23 states that the "purpose and intent of this rule is to establish ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers with respect to the issuance of municipal securities." The rule defines the financial advisory relationship as follows:

> a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to the issuance of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue.

An exception is provided that recognizes that certain matters are integral to an underwriting engagement: "a financial advisory relationship shall not be deemed to exist when, in the course of acting as an underwriter and not as a financial advisor, a broker, dealer or municipal securities dealer renders advice to an issuer, including advice with respect to the structure, timing, terms and other similar matters concerning the issuance of municipal securities."

The MSRB issued guidance[32] regarding the interplay of Rule G-23 and characterization as a "municipal advisor":

> This notice . . . provides interpretive guidance on when a dealer may be precluded by Rule-23(d) from underwriting an issue of municipal securities due to having served as financial advisor with respect to that issue. Rule G-23 is solely a conflicts rule.
>
> Accordingly, *this notice does not address whether provision of the advice permitted by Rule G-23 would cause the dealer to be considered a "municipal advisor" under the Exchange Act* and the rules promulgated thereunder. (emphasis added)

The MSRB provided clarity regarding when the underwriting exception would apply:

> a dealer that clearly identifies itself in writing as an underwriter and not as a financial advisor from the earliest stages of its relationship with the issuer with respect to that issue (e.g., in response to a request for proposals or in promotional materials provided to an issuer) will be considered to be "acting as an underwriter" under Rule G-23(b) with respect to that issue.

This clear identification as an underwriter at the earliest stages of a relationship is identical to the language the MSRB used in the Rule G-17 context.

MSRB Proposed Rule G-36. Proposed Rule G-36 provides: "In the conduct of its municipal activities on behalf of municipal entities, a municipal advisor shall be subject to a fiduciary duty, which shall include a duty of loyalty and a duty of care."[33]

[29] MSRB Notice 2012-25 (May 7, 2012).

[30] MSRB Notice 2012-38 (Jul. 18, 2012).

[31] MSRB Notice 2013-08 (Mar. 25, 2013).

[32] MSRB, *Guidance on the Prohibition on Underwriting Issues of Municipal Securities for Which a Financial Advisory Relationship Exists Under Rule G-23*. (Nov. 27, 2011).

[33] MSRB Notice 2011-14 (Feb. 14, 2011).

Conclusion

The Rules, as noted, provide informative guidance, helpful clarifications, and new exemptions from the definition of "municipal advisor." As the 777-page Adopting Release is reviewed by affected parties and industry participants, undoubtedly questions and the need for further clarifications will arise. John Cross, the Director of the SEC's Office of Municipal Securities, has encouraged industry groups to submit questions to the SEC staff. Accordingly, we can expect further comment on and clarification of the Rules over the next few months.

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