HAWKINS ADVISORY

MUNICIPAL ADVISOR RULES
SEC Staff posts FAQs; SEC Delays Effective Date

Introduction

On January 10, 2014, the staff of the Securities and Exchange Commission (the "SEC") posted on the SEC's website a series of "Frequently Asked Questions" and related responses ("FAQs"[1]) [http://www.sec.gov/info/municipal/mun-advisors-faqs.shtml] relating to the SEC's final rules (the "Rules") governing the definition, registration, and regulation of municipal advisors that were issued on September 18, 2013.[2] The Rules were to have become effective on January 13, 2014, but have been stayed until July 1, 2014.[3] A Hawkins Advisory dated October 3, 2013 [http://www.hawkins.com/news_view.asp?langdisp=&id=154], described and analyzed the Rules. This Hawkins Advisory summarizes and analyzes the FAQs.

Although the effective date of the Rules has been stayed, the statutory definition of "municipal advisor," the associated fiduciary duty, and the requirement to register as a municipal advisor with both the SEC and the Municipal Securities Rulemaking Board ("MSRB") continue to be in effect, as they have been since October 1, 2010.

The Rules provide definitions, clarify the statutory exclusions, and establish new exemptions from the definition of "municipal advisor." Nevertheless, a number of questions arose from the Rules and the related Release, some of which were addressed by the FAQs. Key issues addressed by the FAQs, which are described further below, include the following:

- What constitutes "advice," and how the information presented to a municipal entity can be "sufficiently limited so that it does not involve a recommendation that constitutes advice."
- How to satisfy the "general information" exclusion from "advice."
- The effect of disclosures and disclaimers on the advice analysis.
- How a broker-dealer may provide business promotional material without being considered a municipal advisor.
- The scope of the RFP/RFQ exemption.
- The scope of the independent registered municipal advisor ("IRMA") exemption.
- The scope of the underwriter exclusion, including the availability of this exclusion with respect to certain post-issuance advice.

[1]The guidance was provided by the staff of the Office of Municipal Securities. The guidance cautions that the responses were prepared by and represent the views of the staff and that the SEC neither approved nor disapproved the FAQs or the interpretive answers.

[2]SEC Rel. No. 34-70462 (Sept. 20, 2013), 78 Fed. Reg. 67468 (Nov. 12, 2013) (the "Release").

[3]SEC Rel. No. 34-71288 (Jan. 13, 2014).

Advice

Advice Standard. Under the statute[4], a key factor in determining whether one is a "municipal advisor" is whether one is providing "advice." The statute does not define "advice." The Rules provide an "advice standard," but do so in the negative: "advice excludes . . . the provision of general information that *does not involve a recommendation* regarding municipal financial products or the issuance of municipal securities." (emphasis added)

Recommendation. The FAQs emphasize that the key consideration in determining whether a person is providing "advice" is whether a "recommendation" is being made. The FAQs state that: "[t]he focus of the advice standard in the Final Rules is whether or not, under all the relevant facts and circumstances, the information presented to a municipal entity or obligated person is sufficiently limited so that it does not involve a recommendation that constitutes advice." In the Release, the SEC stated that "the determination of whether a recommendation has been made is an objective rather than a subjective inquiry." In the FAQs, the SEC staff elaborated that an "important factor" in the determination of whether advice is given is whether *"considering its content, context and manner of presentation,* the information communicated to the municipal entity or obligated person reasonably would be viewed as a suggestion that a municipal entity or obligated person *take action or refrain from taking action* regarding municipal financial products or the issuance of municipal securities." (emphasis added)

The FAQs distinguish between various communications that constitute recommendations and those that provide factual general information that does not include "subjective assumptions, opinions or views." Examples of communications that are considered general information that do not involve providing a recommendation include objective information concerning the speaker's professional qualifications, general market information, and general information concerning debt financing structures and government financing programs. Although the FAQs state that purely factual information that is "particularized . . . in limited respects" may be conveyed consistent with the Rules' general information exclusion, it also emphasizes that highly particularized factual information may be deemed to constitute an implicit recommendation even if purely factual in nature, as, for example, the presentation of highly particularized options. The FAQs express some further detailed views of specific factual information that may appropriately be included in business promotional material outside or within an RFP process and in other specific contexts so that such communications would not constitute recommendations. Also, see the descriptions of refunding analyses and remarketing agents below.

Disclosures and Disclaimers. The FAQs state that certain key disclosures and disclaimers will be factors in determining whether information is "advice":

> The staff believes that the following disclosures and disclaimers, *clearly and conspicuously stated, in written materials that accompany communications to a municipal entity or obligated person,* would be factors that weigh against treatment of information as a recommendation that constitutes advice: (a) this person is not recommending an action to the municipal entity or obligated person; (b) this person is not acting as an advisor to the municipal entity or obligated person and does not owe a fiduciary duty . . .; (c) this person is acting for its own interests; and (d) the municipal entity or obligated person should discuss any information and material contained in this communication with any and all internal or external advisors and experts that the municipal entity or obligated person deems appropriate before acting on this information or material. (emphasis added)

The FAQs caution, however, that "such disclosures and disclaimers are not controlling and must be considered in the context of a person's overall course of conduct, taking into account all the relevant facts and circumstances."

[4]Section 15B(e)(4) of the Securities Exchange Act of 1934.

The FAQs provide guidance regarding disclaimers in the specific context of promotional materials. The FAQs state that if certain disclaimers are present, together with those quoted above, this would "weigh against treatment of business promotional materials as a recommendation that constitutes advice." These additional disclaimers are:

> (a) a statement that the broker-dealer seeks to serve as an underwriter on a future transaction and not as a financial advisor or municipal advisor consistent with the MSRB Rule G-23 interpretive guidance; (b) a description of the arm's length nature of the underwriter's role consistent with the disclosure required by MSRB Rule G-17 in this regard; and (c) a statement that the information provided is for discussion purposes only in anticipation of being engaged to serve as underwriter.

Refunding Analyses. As noted above, under the Rules, materials that are sufficiently general will not be considered "advice" within the meaning of the statutory definition of "municipal advisor." In the FAQs, the SEC staff provides specific guidance in the context of business promotional materials that analyze potential refunding structures. Information that analyzes an issuer's outstanding debt portfolio would not be a "recommendation" and therefore would not be "advice," if it is "based on the assumption that the refunding bonds had the same debt structure involving substantially level annual debt service payments and the same final maturity date as the outstanding bonds." On the other hand, the FAQs caution that "presentations of more particularized refunding options that involve restructuring the issuer's outstanding debt likely would imply a recommendation."

The requirement that the refunding analysis must assume that the refunding bonds have substantially level annual debt service and do not mature after the final maturity date of the outstanding bonds is unnecessarily restrictive. Permitting issuers and obligated persons to receive information as to a broader range of potential refunding structures would be constructive.

Requests for Proposals and Qualifications (RFPs/RFQs)

The Rules provide an exemption from the municipal advisor definition for 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."[5] The FAQs provide two important clarifications regarding this exemption. First, "an RFP or RFQ does not need to be part of a municipal entity's formal procurement process to be consistent with the requirements of the RFP exemption." Second, any so-called "mini-RFP" must be "sent to either the entire pool of pre-screened or pre-qualified market participants or at least three members of such pool." To emphasize, this requirement is based on how many firms the mini-RFP is sent to, not how many firms respond. Also, although the FAQs do not state that an RFP or RFQ must take any specific form for the exemption to be available to respondents, an "illustrative example" of several procedural parameters that the SEC staff deems consistent with the exemption is provided. Those parameters are:

> (a) the municipal entity or obligated person, or a registered municipal advisor acting on their behalf, conducts the RFP or RFQ; (b) a particular objective is identified in the RFP or RFQ (e.g., ideas on how to structure a particular issuance of municipal securities to finance an identified capital project or program); (c) the RFP or RFQ is open for a specified period of time that is reasonable under the facts and circumstances and that is not indefinite (e.g., absent particular complexity or exigent or other circumstances that might support a longer or shorter specific period of time, an open period of up to six months generally is considered reasonable); and (d) the RFP or RFQ involves a competitive process under the facts and circumstances (e.g., the RFP or RFQ is sent to at least three reasonably competitive market participants or the RFP or RFQ is publicly

[5] 17 CFR § 240.15Ba1-1(d)(3)(iv).

disseminated by posting it on the official website of the municipal entity or obligated person).[6]

Independent Registered Municipal Advisor Exemption

The Rules provide an exemption from the municipal advisor definition if the municipal entity has engaged an "independent registered municipal advisor [which] is providing advice with respect to the same aspects of the municipal financial product or issuance of municipal securities."[7] The FAQs clarify that a broker-dealer that has given express notice of its intent to not act as a municipal advisor subject to fiduciary duties to *each of* the issuer (or obligated person) and its IRMA may "provide advice . . . beyond the type . . . permitted to be provided pursuant to the underwriter exclusion." (see *"Underwriter Exclusion"* below)

The FAQs provide the following regarding such exemption:

- The IRMA can be serving in a "general capacity (as compared, for example, to a municipal advisor that advises on a particular municipal securities transaction), on retainer." In doing so, "the scope of that municipal advisor's representation of the municipal entity or obligated person [must cover] advice with respect to the same aspects of the issuance of municipal securities or municipal financial products as the person who is seeking to rely on the exemption."
- The municipal entity could provide the required representations "in any reasonable manner, including one written disclosure to multiple transaction participants, to show that it is represented by, and will rely on the advice of, its independent registered municipal advisor."
- The single written disclosure referenced in the preceding bullet could be done by a posting on the issuer's website. The FAQs state:

  > The staff further believes that a municipal entity could provide the required representations in one written disclosure to multiple market participants by posting it publicly on its official website and clearly stating in the written disclosure that by publicly posting the written disclosure the municipal entity intends that market participants receive and use it for purposes of the independent registered municipal advisor exemption.

- The IRMA "does not need to be present for every conversation."

Independent. The Rules define "independent" in the context of this exemption as follows:

> For purposes of [the IRMA exemption], the term *independent registered municipal advisor* means a municipal advisor registered pursuant to section 15B of the Act (15 U.S.C. 78o-4) and the rules and regulations thereunder and that is not, and within at least the past two years was not, associated (as defined in section 15B(e)(7) (15 U.S.C. 78o-4(e)(7)) of the Act) with the person seeking to rely on this paragraph (d)(3)(vi).

What is unclear from the Rules, and is not answered by the Release or the FAQs, is whether the requirement that there not be an association for the past two years relates to the municipal advisor as an entity or to the individuals

[6]For a "mini-RFP," the FAQs note that "an open period of up to three months generally is considered reasonable."

[7]17 CFR § 240.15Ba1-1(d)(3)(vi).

at the municipal advisor firm providing the particular advice.[8] An interpretation of the word "independent" that would exclude a firm as a whole if any individual, regardless of whether assigned to the particular bond issue, had been associated with a broker-dealer seeking to rely on the IRMA exemption is unnecessarily restrictive. It is our understanding that the SEC staff will be providing additional frequently asked questions and responses to be released before the delayed effective date of July 1, 2014, and that additional guidance on this issue is currently under active consideration.

Investment Adviser Exclusion

The statute and the Rules provide an exclusion from the definition of "municipal advisor" for any "investment adviser registered under the Investment Advisers Act of 1940 . . . to the extent that such registered investment adviser . . . is providing investment advice in such capacity."[9] The Rules also provided, however, that the exclusion did not apply to "advice concerning municipal derivatives." This limitation caused concern that it could include derivatives in an issuer's investment portfolio regardless of whether linked to an issuance of municipal securities. The FAQs provide that this is not the case. The FAQs state:

> The staff believes that "advice concerning municipal derivatives" was intended to be limited to advice concerning those municipal derivatives used by municipal entities or obligated persons in connection with the issuance of municipal securities (as contrasted with investment advisory services regarding municipal derivatives in an investment portfolio).

The use by a municipal issuer of an investment adviser registered with the SEC under the Investment Advisers Act of 1940 does not, in itself, satisfy the IRMA exemption unless the investment adviser is also registered as a municipal advisor with the SEC and the MSRB.

Underwriter Exclusion

General. The statute and the Rules[10] provide an exclusion from the definition of "municipal advisor" for an underwriter. The Release advised that a "contractual engagement" would qualify the person as an "underwriter" and therefore would exclude such person from the "municipal advisor" definition. The FAQs state that the engagement can be demonstrated by a writing (with the features described below), but also make clear that the "engagement" does not require the formality of a formal engagement letter or compliance with applicable procurement laws. The key in determining whether a "contractual engagement" exists is an affirmative action by the municipal entity and not only a broker-dealer's unilateral action. The FAQs state:

> [A]n important basic component of the underwriter exclusion involves a decision by the municipal entity or obligated person to select a broker-dealer to serve as underwriter on a particular issuance of municipal securities that is affirmative in nature and is informed by the full disclosure about the role of the underwriter as required by MSRB Rule G-17. (By contrast, in the staff's view, a broker-dealer's

[8] The Release cites for support the standard used in the context of MSRB Board membership, which is clearly tested by the individual at issue:

> A two-year period is also used to determine whether an individual is a "public representative" for purposes of MSRB Board membership. Specifically, for purposes of determining whether an individual is a public representative, the MSRB defined the term "no material business relationship" to mean that, at a minimum, the individual is not and, within the last two years, was not associated with a municipal securities broker, municipal securities dealer, or municipal advisor, and that the individual does not have a relationship with any municipal securities broker, municipal securities dealer, or municipal advisor, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision making of the individual.

[9] 17 CFR § 240.15Ba1-1(d)(2)(ii).

[10] 17 CFR § 240.15Ba1-1(d)(2)(i).

> unilateral action to identify itself in writing as an underwriter and not as a financial advisor under MSRB Rule G-23 for purposes of that conflicts rule is insufficient to establish that the broker-dealer meets the underwriter exclusion . . . .)

Engagement Letter. If the exclusion is to be met by use of an engagement letter, such letter must have the following features:

> (a) the governing body or any duly authorized official of the municipal entity responsible for municipal finance has executed, approved, or acknowledged the engagement letter in writing;
>
> (b) the engagement letter clearly relates to providing underwriting services;
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> (c) the engagement letter clearly states the role of the broker-dealer in the transaction;
>
> (d) the engagement letter relates to a particular issuance of municipal securities that the municipal entity or obligated person anticipates issuing and is not a general engagement for underwriting services that does not relate to any particular transaction; and
>
> (e) the engagement letter or separate writing done at or before the time of the engagement provides all disclosures that are required to be made by underwriters by the time of an engagement under MSRB Rule G-17, including disclosures about the role of the underwriter, the underwriter's compensation, and actual or potential material conflicts of interest (excluding only those permitted to be disclosed after the time of engagement under MSRB Rule G-17).

Notably, the use of an engagement letter is not the exclusive means for establishing that a broker-dealer satisfies the underwriter exclusion. The FAQs advise as follows:

> [I]t is the staff's view that a broker-dealer could demonstrate a sufficient relationship to a particular transaction if the broker-dealer received an oral or written acknowledgement of engagement from a duly authorized official of the issuer responsible for the area of municipal finance (e.g., a telephone call or e-mail from an issuer official to acknowledge the selection of an underwriter after the governing body of the issuer has met and voted to approve the selection of the broker-dealer as underwriter for a particular issuance of municipal securities) and if the broker-dealer has made the disclosures required to be made under MSRB Rule G-17 at or before the time of engagement.

Interplay with MSRB Rule G-17. Regardless of whether the engagement for purposes of the underwriter exclusion is satisfied by an engagement letter, a telephone call, or an e-mail, the broker-dealer must have made the disclosures required to be made under MSRB Rule G-17 at or before the time of engagement.[11] This requirement that a broker-dealer satisfy the Rule G-17 disclosure requirements as a precondition to its reliance upon the underwriter exclusion is likely to lead broker-dealers to provide them earlier in the financing process than is currently the case.

Interplay with MSRB Rule G-23. The FAQs caution that the restrictions applicable to a "financial advisor" within the meaning of MSRB Rule G-23 also apply to a "municipal advisor":

[11] A broker-dealer is required under MSRB Rule G-17 to disclose (i) the arm's-length nature of the relationship at or before a response to a request for proposals or promotional materials are delivered to the issuer, (ii) underwriter's compensation (whether contingent; how calculated) at or before the time of engagement, and (iii) dealer-specific conflicts of interest known as of the time of engagement. MSRB Notice 2013-08 (Mar. 25, 2013); MSRB Notice 2012-25 (May 7, 2012).

> A broker-dealer that is also a registered municipal advisor [and that is serving] as the municipal advisor to a municipal entity in the early stages of a financing transaction involving the issuance of municipal securities [may not] then switch roles to serve as the underwriter when the municipal entity decides to proceed with that issuance of municipal securities.

Post-Issuance Advice. If there is a material omission in an official statement that is discovered after the financing has closed and the underwriting period has terminated, advice by the broker-dealer that served as the underwriter remains within the scope of the underwriter exclusion. The reasoning set forth in the FAQs is as follows:

> The Adopting Release provides that any advice with respect to the issuance of municipal securities given after the underwriting period has terminated would generally be municipal advisory activity outside the scope of the underwriter exclusion. In this example, however, the broker-dealer would be providing advice that is (a) integral to its underwriting responsibility in connection with the issuance of municipal securities (i.e., to review the offering document and reasonably conclude that the municipal entity prepared materially sufficient disclosure) and (b) promoting compliance with the anti-fraud provisions of the federal securities laws. Accordingly, it is the staff's view that such advice would be within the scope of the underwriter exclusion.

However, particularized advice regarding continuing disclosure filings may not be within the scope of the underwriter exclusion. For example, assessing whether an event is "material" under the federal securities laws may be "municipal advice." In contrast, assisting a municipal entity in compiling specific factual information to complete an annual disclosure filing would not, without more, involve a "recommendation" and therefore would not be "municipal advice."

Remarketing Agent Services. The specific context of variable rate demand securities is separately addressed in the FAQs, which state the SEC staff's views that a broker-dealer acting as remarketing agent may not rely upon the underwriter exclusion to provide recommendations, but may be able to both discharge rate-setting and remarketing duties and provide highly particularized factual information concerning the remarketing of the issue, including "*factual* information on how the interest rate would be impacted by a change [in] interest rate mode or change in the liquidity facility provider" (emphasis added). The FAQs also express, however, the SEC staff's further view that a remarketing agent's communications that included a "recommendation, opinion, or view" as to such changes would constitute advice.

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