HAWKINS ADVISORY

MUNICIPAL ADVISOR REGISTRATION—EFFECT OF PROPOSED RULES ON ISSUER AND OBLIGOR BOARDS

BACKGROUND

Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (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, (1) require municipal advisors to register with the Securities and Exchange Commission (the "SEC"), (2) establish a fiduciary duty between a municipal advisor and a municipal entity for which it is acting as a municipal advisor,[1] and (3) subject municipal advisors to additional anti-fraud provisions.[2] The SEC adopted an interim final temporary rule (Rule 15Ba2-6T; the "Temporary Rule") to enable municipal advisors to satisfy the statutory requirement to register with the SEC, which rule became effective October 1, 2010, and expires on December 31, 2011.

The SEC on December 20, 2010 (Rel. No. 34-63576; the "Proposing Release")[3] proposed permanent rules (Rules 15Ba1-1 through -7; collectively, the "Proposed Rule" and, together with the Temporary Rule, the "Rules") to implement Section 975, which would take effect on a date yet to be determined. The Proposing Release requests comments on the Proposed Rule, to be received on or before February 22, 2011.

Prior to the Dodd-Frank Act, a municipal financial advisor was not subject to registration with the SEC unless it was either a broker or dealer (subject to registration under the Exchange Act) or an investment adviser (subject to registration under the Investment Advisers Act of 1940; the "40 Act"). Section 3(a)(4) of the Exchange Act defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." Section 3(a)(5) of the Exchange Act defines "dealer" as "any person engaged in the business of buying and selling securities for such person's own account." Section 202(a)(11) of the 40 Act defines "investment adviser" as "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."

The underlying purpose of Section 975 of the Dodd-Frank Act was to subject independent municipal financial advisors to SEC registration and regulatory requirements without regard to whether they can be characterized as a "broker," a "dealer," or an "investment adviser." In doing so, however, as analyzed in detail below, it created a very sweeping definition of "municipal advisor," which does not include either an "engaged in the business" or a compensation component as a requirement, both of which have been core elements of the existing regulatory scheme. Although other aspects of the Proposed Rule also require further consideration, this Advisory focuses upon the potential effects of the Proposed Rule upon municipal security issuer and obligor boards.

DEFINITION; EXCLUSIONS

Section 975 defines the term "municipal advisor" to mean "a person (who is not a municipal entity[4] or an employee of a municipal entity) that (i) provides advice to or on behalf of a municipal entity or obligated person[5] with respect to municipal financial products ["municipal derivatives," "guaranteed investment contracts" including forward supply contracts, or "investment strategies"][6] or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial

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1 "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)]

2 "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)]

3 76 Fed. Reg. 824 (Jan. 6, 2011).

4 "[A]ny 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)]

5 "[A]ny 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." [Exchange Act § 15B(e)(10)] This definition tracks the definition of "obligated person" in SEC Rule 15c2-12.

6 Proposed Rule § 240.15Ba1-1(f), Exchange Act § 15B(e)(2), Exchange Act § 15B(e)(3), and Proposed Rule § 240.15Ba1-1(b), respectively.

products or issues; or (ii) undertakes a solicitation of a municipal entity." Section 975 further provides, however, that the term "municipal advisor" does *not* include, among others, (1) "a broker, dealer, or municipal securities dealer serving as an underwriter," (2) "any investment adviser registered under the Investment Advisers Act of 1940," or (3) "attorneys offering legal advice or providing services that are of a traditional legal nature." The term has basically the same meaning in the Rules.[7]

MEMBERS OF GOVERNING BODIES

The definition of "municipal advisor" in the Dodd-Frank Act expressly excludes "a municipal entity or an employee of a municipal entity." The Dodd-Frank Act does not provide a definition of the term "employee." In the Proposing Release, the SEC draws a distinction between elected and non-elected members of the governing body of a municipal entity:

> The Commission believes that the exclusion from the definition of a "municipal advisor" for "employees of a municipal entity" should include any person serving as an elected member of the governing body of the municipal entity to the extent that person is acting within the scope of his or her role as an elected member of the governing body of the municipal entity. "Employees of a municipal entity" should also include appointed members of a governing body to the extent such appointed members are ex officio members of the governing body by virtue of holding an elective office. The Commission does not believe that appointed members of a governing body of a municipal entity that are not elected ex officio members should be excluded from the definition of "municipal advisor." The Commission believes that this interpretation is appropriate because employees and elected members are accountable to the municipal entity for their actions. In addition, the Commission is concerned that appointed members, unlike elected officials and elected ex officio members, are not directly accountable for their performance to the citizens of the municipal entity.

In short, the SEC is determining that the exclusion for "employees" applies only to elected members of the governing body and not to non-elected members. The SEC requests comments on whether such a distinction is appropriate:

> The Commission is proposing to exclude from the definition of "municipal advisor" elected members of a governing body of a municipal entity, but to include appointed members of a municipal entity's governing body unless such appointed members are ex officio members of the governing body by virtue of holding an elective office. Are these distinctions appropriate? Please explain. Are there other persons associated with a municipal entity who might not be "employees" of a municipal entity that the Commission should exclude from the definition of a "municipal advisor"?

Note that none of this applies to obligated persons, and "a person . . . that provides advice to or on behalf of a municipal entity *or obligated person* [,if not itself a municipal entity,] with respect to municipal financial products or the issuance of municipal securities" would be required under the Proposed Rule to register as a municipal advisor. The obligated person definition is broad, and would embrace a wide range of obligors receiving the benefit of exempt facility, qualified 501(c)(3), and other municipal finance vehicles, including not only for-profit entities, such as airlines, but also for-profit and non-profit health care systems, universities, etc., to the extent they are committed to support the payment of municipal securities.

ANALYSIS

The construct reflected in the Proposing Release is fundamentally flawed. The SEC treats members of a governing body of any municipal entity or obligated person as municipal advisors, subject (with respect to municipal entities) to a limited exclusion for "elected" members.[8] The problem is not simply the artificial distinction between elected and non-elected members, but more fundamentally the Proposed Rule fails to recognize that the governing board of a municipal entity cannot be a municipal advisor to such entity. The municipal entity acts through its governing body, which is necessarily comprised of individual members. Accordingly, the exception for a "municipal entity" should properly be interpreted to mean all governing body members. The same is the case for obligated persons. Thus, comments to the SEC should not be limited to responding to the SEC's question of whether the distinction between elected and non-elected is appropriate, but should note the fundamental misunderstanding and confusion underlying the construct set forth in the Proposing Release as it applies to both municipal entities and obligated persons.

Furthermore, the notion that non-elected members of boards of municipal entities are not accountable is incorrect. Even non-elected members are generally treated as public officers and are subject to removal for cause. In addition, non-elected board members are in almost all cases appointed by elected officials pursuant to explicit provisions of a statute passed by elected officials. That state statute does not distinguish board members or voting strength on a board between elected and appointed members. For a federal provision to now intrude on this basic form of state governance without

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

[8] Section 15B(e)(4) excludes from the definition of "municipal advisor" an "employee of a municipal entity." Thus, an employee of a particular governmental entity who serves in an *ex officio* capacity on the board of another governmental entity should be excluded from the definition of "municipal advisor". The SEC should confirm that such reading is correct.

any Congressional history or legislative intent support seems quite arbitrary.

The issuance of municipal securities and municipal financial products are legitimate matters to be examined, debated, and acted upon by municipal entities and obligated persons. To subject non-elected governing body members of municipal entities, and all employees and governing body members of obligated persons, to the registration requirements and expense, federal fiduciary standards, and federal securities law liability, can only have the effect of discouraging participation. This is flawed public policy and counter-productive to good governance.

Moreover, subjecting members of municipal entities' governing bodies to these requirements may violate the Tenth Amendment to the United States Constitution, which reserves to the States those powers not delegated to the United States by the Constitution. The legislative history of the Dodd-Frank Act is devoid of legislative intent on this point.

The SEC may argue that registration is required only for those persons who are in fact providing financial advice. The problem with such a defense of the Proposing Release construct is that the definition of financial advice is so broad ("municipal financial products or the issuance of municipal securities") as to potentially include the adoption of an approval resolution authorizing a municipal bond issuance if at such meeting questions are asked by board members probing the "structure, timing, terms, or other similar matters," or a finance committee recommendation to the governing board relating to the issuance of municipal securities or financial products. Indeed, it is common practice for a proposed financial transaction to be considered first by a finance committee (or other specially formed committee) of a board with a recommendation made by such committee to the full board as to its structure, timing, terms and related matters.[9] Regulation in this manner is ill-conceived. The SEC has other means to encourage and enforce the proper conduct of governing bodies of municipal entities and obligated persons, including interpretive releases and municipal enforcement actions. Moreover, many obligated persons are already subject to regulation, including SEC registrants, public utilities, and financial institutions. Rather than discouraging participation on governing bodies by requiring registration and additional potential liabilities, the SEC should be encouraging greater participation of individuals knowledgeable and experienced in finance, and the potential for the municipal advisor provisions to attach being dependent upon whether "advice" is given by a board member would have a chilling effect on board members expressing their views. As a matter of public policy, the expression of such views should be encouraged, not discouraged.

Hawkins Delafield & Wood LLP expects to submit a comment letter to the SEC on the Proposed Rule. In that comment letter, we will expand upon and provide additional support for the concerns summarized above. We encourage you to submit your own comment letter, and please let us know if there are additional concerns you would like us to bring to the attention of the SEC.

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[9] In New York State, for example, board members of each state and local authority that issues debt are required to establish a finance committee, and by statute it "shall be the responsibility of the members of the finance committee to review proposals for the issuance of debt by the authority and its subsidiaries and make recommendations." N.Y. Public Authorities Law § 2824(8).

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